

## MEMORANDUM

**TO:** Chairman William H. Donaldson

**FROM:** Paul F. Roye  
Division of Investment Management

**DATE:** June 9, 2003

**RE:** Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

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In correspondence addressed to you dated March 26, 2003, Richard Baker, Chairman of the House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises asked the Securities and Exchange Commission (the "Commission") to respond to a number of questions related to mutual funds.

At your request, the staff diligently has endeavored to answer these questions as completely as possible. There may be a few instances, as noted, where the staff has incomplete information. The questions presented in Chairman Baker's letter are set forth below in bold italics, followed by the staff's responses. We recognize that the views expressed in this memorandum may not necessarily reflect your views or those of the other Commissioners.

***1. The GAO recently issued another study indicating that fees for actively managed equity funds have risen in recent years. Similarly, the Commission's 2000 study also concluded that mutual fund fees were rising. At the Subcommittee hearing, Mr. Bogle suggested that the GAO report actually underreported the extent to which fees have increased. This upward trend in fees suggests that competitive forces are not driving fees down. What steps might help promote greater transparency of fees for investors, and greater fee-based competition among funds? Please assess the relative utility of information provided on shareholder statements and semi-annual shareholder reports versus the prospectus and statement of additional information.***

For more than 60 years, Congress and the Commission have sought to protect the interests of fund investors with respect to fund fees and expenses by relying on mutual fund directors and procedural safeguards to reduce the conflicts of interest that could lead to inappropriate or inflated fees and ensuring that investors receive adequate disclosure of fees and expenses to allow them to make informed investment decisions. Since 1988, the

Commission has required uniform cost disclosure in mutual fund prospectuses to help investors make informed investment decisions. Today, the Commission continues to address concerns about investors' understanding of mutual fund expenses. The response below discusses the extent to which cost-based competition currently exists in the fund industry and describes the current framework for disclosure of mutual fund expenses and Commission efforts to improve investor awareness of fund expenses. The response also discusses the Commission's recent proposal to require disclosure in shareholder reports of expenses borne by fund shareholders and a suggested alternative approach that would require disclosure of mutual fund expenses in investors' quarterly account statements. Finally, the response addresses the manner in which the Commission's proposed requirement for expense disclosure in reports to shareholders complements the current requirement for disclosure of expenses in the fund prospectus.

**A. Cost-Based Competition Among Mutual Funds**

As discussed below, while there is some evidence that mutual fund expense ratios have risen over time, it is not clear that the overall costs of owning mutual fund shares has risen. Moreover, although it is difficult to measure the extent to which cost-based competition exists in the mutual fund industry, there is a basis for arguing that significant competition based on costs exists in the mutual fund industry.

At the end of 2000, the Division of Investment Management completed a Report on Mutual Fund Fees and Expenses (the "Staff Fee Study").<sup>1</sup> The Staff Fee Study concluded that despite increases in fund expense ratios, the overall cost of owning fund shares may not have risen if changes in sales loads, which generally decreased during the

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<sup>1</sup> Division of Investment Management, SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES, at 9 (Dec. 2000).

period of the study, were taken into consideration.<sup>2</sup> We further concluded that the increase in mutual fund expense ratios since the 1970s could be attributed primarily to changes in the manner that distribution and marketing charges were paid by mutual funds and their shareholders. Many funds have decreased or replaced front-end loads, which are not included in a fund's expense ratio, with ongoing 12b-1 fees, which are included in a fund's expense ratio. This change complicates the comparison of current expense ratios with expense ratios from earlier periods. The Staff Fee Study analyzed the expenses of all stock and bond funds for the years 1979, 1992, and 1995 through 1999, in order to determine how fee levels have changed over time.<sup>3</sup> The Staff Fee Study found that the expense ratio of the average mutual fund class rose from 0.73% in 1979 to 0.99% in 1995, fell in 1996, 1997, and 1998 to 0.91%, and then rose to 0.94% in 1999.<sup>4</sup>

The table below updates the study results to include 2000, 2001 and preliminary results for 2002.

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<sup>2</sup> Sales loads, which are paid by an investor upon purchase or sale of a fund's shares, are not taken into consideration when calculating expense ratios.

<sup>3</sup> The Staff Fee Study selected 1979 as a benchmark because it is the year before rule 12b-1 distribution fees were first permitted. A 12b-1 fee is a fee charged by some mutual funds against fund assets to pay for marketing and distribution activities. *See* section 12(b) of the 1940 Act; rule 12b-1 thereunder. The Staff Fee Study also analyzed data for 1992 because it is the first year for which the SEC has expense data in electronic format, and the years 1995 through 1999 to get a more recent picture of trends in fund expenses. Staff Fee Study, *supra* note 1, at 30.

<sup>4</sup> Staff Fee Study, *supra* note 1, at 41. The Staff Fee Study focused on expense ratios weighted by class size, rather than an equally weighted average. The Staff Fee Study noted that evaluations of fund fees should generally give more weight to classes with more assets (and more shareholders) and that the typical fund investor is likely to own one of the larger classes. *Id.*

### Expense Ratio Trends: All Classes

	Unweighted Average Expense Ratio	Weighted Average Expense Ratio
1979	1.14%	0.73%
1992	1.19%	0.92%
1995	1.30%	0.99%
1996	1.32%	0.98%
1997	1.33%	0.95%
1998	1.35%	0.91%
1999	1.36%	0.94%
2000	1.37%	0.92%
2001	1.38%	0.92%
Preliminary 2002 <sup>5</sup>	1.40%	0.93%

The table indicates that mutual fund expense ratios remained relatively stable between 1999 and 2002. The weighted average expense ratio was 0.93% in 2002 compared to 0.94% in 1999. We believe this may reflect that the assets of many bond funds increased during the period while the assets of many stock funds declined. These trends would tend to lower the weighted average expense ratio because bond funds as a group have lower expense ratios than stock funds.

In addition, recent analysis by the United States General Accounting Office (“GAO”) noted that the asset-weighted average expense ratio for 46 large stock funds analyzed by GAO had declined from 0.74 percent in 1990 to 0.70 percent in 2001, but that the asset-weighted average expense ratio of these funds has increased recently by

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<sup>5</sup> The data for 2002 is preliminary because it is derived from the February 2003 edition of the Morningstar *Principia* database and may not contain expense ratios for funds with December 31 fiscal year-ends.

about 11 percent, from 0.63 percent in 1999 to 0.70 percent in 2001.<sup>6</sup> In looking at the expenses of 30 bond funds over this period, the average bond fund expense ratio decreased by 5.3%.

The decrease in bond fund expense ratios may reflect economies of scale arising from an increase in the assets of bond funds in the sample and the increase in stock fund expense ratios may reflect the decrease in assets of some stock funds in the sample.

An additional factor – the behavior of performance-based fees paid by certain large funds – may account for a portion of the increase in the average stock fund expense ratio.<sup>7</sup> For example, certain stock funds in the sample performed better than their benchmark indices in 2001 and 2002, with the result that their performance-based fees increased during these years. Because these funds had performed worse than their benchmark indices in 1998, 1999 and 2000, their performance-based fees had decreased during those years.

There is also empirical evidence suggesting that there is significant competition based on costs in the fund industry. Three fund groups that have been characterized as featuring relatively low costs have increased their share of total fund assets from 17% at

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<sup>6</sup> Statement for the Record by Richard J. Hillman, Director, Financial Markets and Community Investment, GAO, MUTUAL FUNDS: INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE, at 2 & 6-7 (March 12, 2003) (“March 2003 GAO Report”). A June 2000 GAO report had concluded that “the expense ratios charged by the largest funds were generally lower in 1998 than their 1990 levels, but this decline did not occur consistently over this period.” GAO, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION, at 8 (June 7, 2000) (“June 2000 GAO Report”). It should be noted that when we analyzed the stock funds in the GAO sample using the methodology employed in our 2000 fee study we found that average expense ratios increased 5.6%. The difference in results can be attributed to differences in methodology with respect to how expense ratios based on varying fund fiscal years were assigned to calendar years for the purposes of analysis.

<sup>7</sup> Mutual fund performance fees typically reflect the results of a fund’s performance compared to the performance of a securities index over a rolling thirty-six month period.

the beginning of 1990 to more than 26% at the end of 2002.<sup>8</sup> In addition, index funds, which are often characterized by lower costs, have grown from less than 2% of stock fund assets in 1990 to 12.6% today.<sup>9</sup> These data suggest that fund groups may effectively compete on the basis of cost for the segment of investors for whom cost is a significant factor in selecting investments.

Moreover, competitive pressures within the industry appear to be prompting an increasing number of fund mergers as fund sponsors attempt to streamline their offerings and eliminate uneconomical funds. Competition also has increased because of the offering of low-cost exchange traded funds (ETFs), which are pooled vehicles generally sponsored by large broker-dealers and stock exchanges that allow investors to buy and sell the funds' shares at any time during the day at market prices. Further, mutual funds face increased competition from sources outside of the fund industry, such as on-line trading accounts and individual account management services provided by investment advisers and broker-dealers.

It is important to note that the choice of distribution channel can significantly influence the amount and type of fund expenses that the investor pays. Typically, fund expenses, such as investment advisory fees, custody fees and 12b-1 fees, are charged to a fund by a fund service provider and are paid by all of the shareholders of a fund in

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<sup>8</sup> The fund groups are American Funds, Fidelity, and Vanguard. See Scott Cooley, *Revisiting Fund Costs: Up or Down?*, MORNINGSTAR.COM <<http://news.morningstar.com/news/MS/Commentary/990219com.html>> (visited April 28, 2003) (characterizing American Funds, Fidelity, and Vanguard as relatively low cost fund families); LIPPER INC., LIPPER DIRECTORS' ANALYTICAL DATA (1st ed. 2003); LIPPER INC., LIPPER DIRECTORS' ANALYTICAL DATA (1st ed. 1989) (data on fund family assets). The asset figures include stock, bond, and money market mutual funds and exclude underlying mutual funds of insurance company separate accounts.

<sup>9</sup> This estimate is based on the Commission staff's analysis of data from MORNINGSTAR PRINCIPIA PRO PLUS, LIPPER DIRECTORS' ANALYTICAL DATA, and Commission filings.

proportion to their investment in the fund. Fund investors therefore may be viewed as indirectly paying fund expenses. In contrast, front-end sales loads are not *fund* expenses, rather they are *shareholder* expenses that shareholders pay directly, and the amounts paid are not included in fund assets. As a result, an investor's choice of distribution method will influence the amount of fund expenses that the investor pays only to the extent that the fund pays a 12b-1 fee to finance the distribution of its shares.

The choice of distribution method, however, generally does not influence the extent to which the investor will pay for the fund's non-distribution expenses, such as investment advisory, custodial fees and other expenses related to the management of the assets of the fund or class. Those expenses generally must be charged to all shareholders in the fund or class on a proportionate basis.<sup>10</sup>

Investors in load funds pay sales loads and 12b-1 fees for the services provided by the broker-dealers that sell the funds' shares to them.<sup>11</sup> The sales loads and 12b-1 fees compensate the broker-dealers and their registered representatives for their selling efforts. The broker-dealers' services may include determinations for customers as to the suitability of particular funds and their classes of shares, and the provision of ongoing investment advice about the funds. A broker-dealer's determination of the suitability of a fund investment for a customer would include consideration of the customer's investment

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<sup>10</sup> The Commission's rules permit funds to issue multiple classes of shares, but each class must have a different arrangement for shareholder services and/or distribution and each class must pay all of the expenses of that arrangement. Each class also may pay a different share of other expenses, except advisory or custodial fees or other expenses related to the management of the fund's assets, but only if these expenses are actually incurred by that class, or if the class receives services of a different kind or to a different degree than other classes. See rule 18f-3(a) under the 1940 Act.

<sup>11</sup> Load funds are funds, or classes of funds, that charge a front-end or a deferred sales load, or funds that charge no sales load but pay a rule 12b-1 fee that is greater than .25% of their net assets.

objectives, and risk tolerances, and the cost structure of the various classes of shares of the fund.

Except as described above, investors in no-load funds generally receive similar but fewer services compared with investors in load funds. Investors that invest directly in no-load funds and classes typically purchase their shares from the fund or the fund's principal underwriter, which provides the investors with prospectuses and other information concerning the funds and classes that it offers. The funds and their principal underwriters may answer questions from investors concerning the characteristics of the funds and classes. The funds and their principal underwriters also process any orders from investors who purchase, redeem or exchange shares of the funds, and they provide the investors with confirmations of transactions and account statements that set forth the dollar amount and number of shares of the funds held by the investors. No-load funds and their principal underwriters typically do not provide investors with investment advice or determinations of the suitability of fund investments.

Typically, the sponsor of a fund establishes the characteristics of the fund, including its investment objectives and policies, and the methods by which the fund's shares will be distributed (and whether the fund will issue multiple classes of shares). The fund's board of directors, however, must approve those characteristics. A fund's sponsor (principal underwriter), and not the broker-dealers that sell the fund's shares, will establish the levels of any applicable sales loads and 12b-1 fees.<sup>12</sup> As a practical matter, however, when a fund sponsor establishes the sales load and the level of rule 12b-1 fees

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<sup>12</sup> With the approval of the fund's board of directors, fund sponsors generally have the freedom to set the fund's sales loads and rule 12b-1 fees at whatever levels they deem appropriate, subject to the limits established by the NASD and the requirements of rule 12b-1 under the 1940 Act.

for a fund, it takes into account the expectations that broker-dealers may have concerning the compensation that they will receive for selling the fund's shares. A number of broker-dealers with large retail networks appear to have a significant amount of leverage in dictating compensation levels because of the limited number of fund share distribution systems and the competition among fund groups in securing prominent positions in these distribution systems. As a result, fund sponsors typically work together with broker-dealers to establish sales loads and rule 12b-1 fees at levels that they believe will provide sufficient incentives to broker-dealers to sell their fund shares.

## **B. Current Disclosure Requirements and Investor Awareness Efforts**

Currently, prospective mutual fund investors receive significant disclosure about fund fees and expenses. Since 1988, Form N-1A, the form used by mutual funds to register their shares under the Securities Act of 1933 (the "1933 Act"), has required every mutual fund prospectus to include a fee table.<sup>13</sup> This table presents fund investors with cost disclosure in a standardized format that is intended to facilitate cost comparisons among funds. The fee table requires a uniform, tabular presentation of all fees and expenses associated with a mutual fund investment. The fee table reflects both (i) transactional costs paid directly by a shareholder out of his or her investment, such as front- and back-end sales loads, and (ii) ongoing expenses deducted from fund assets, such as advisory fees and 12b-1 fees. The table is accompanied by a numerical example that illustrates the total dollar amounts, including both transactional costs paid directly by a shareholder and ongoing asset-based expenses, that an investor could expect to pay on a \$10,000 investment if the fund achieved a 5% annual return and the investor remained

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<sup>13</sup> Item 3 of Form N-1A.

invested in the fund for 1-, 3-, 5-, and 10-year periods. This example is intended to enable a prospective investor to estimate the total costs associated with a fund investment, in order to permit the investor to make an informed cost comparison among funds.

In addition, the Commission requires average annual total returns for the past 1-, 5-, and 10-years (or the life of the fund, if shorter), which are required as part of the risk-return summary in the mutual fund prospectus, to be calculated reflecting the payment of costs, including sales loads and ongoing shareholder account fees.<sup>14</sup> Under rule 482 under the 1933 Act and rule 34b-1 under the 1940 Act, the Commission also requires mutual fund sales material that includes performance information to include similar average annual total return quotations, calculated reflecting the payment of costs.<sup>15</sup> In 2001, the Commission enhanced these disclosure requirements by requiring mutual funds to report their average annual returns in their prospectuses on an after-tax basis as well.<sup>16</sup> This requirement reflects the fact that taxes often represent the largest single expense borne by many fund investors.<sup>17</sup>

In addition to requiring cost disclosure, the Commission has undertaken efforts to educate investors about the significance of the costs that they pay in connection with mutual fund investments. Most notably, in 1999, the Commission introduced the Mutual

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<sup>14</sup> Item 2(c)(2) and Instruction 2(a) to Item 2(c)(2) of Form N-1A.

<sup>15</sup> Rule 482(e)(3) and (5)(ii) under the 1933 Act; rule 34b-1 under the 1940 Act; Item 21(b) of Form N-1A.

<sup>16</sup> Item 2(c)(2)(i) and (iii) of Form N-1A; Investment Company Act Release No. 24832 (Jan. 18, 2001).

<sup>17</sup> See Investment Company Act Release No. 24832 (Jan. 18, 2001) (citing estimate that two and one-half percentage points of the average stock fund's total return is lost each year to taxes).

Fund Cost Calculator (the “Cost Calculator”), an Internet-based tool available on the Commission’s website that enables investors to compare the costs of owning different mutual funds over a selected period.<sup>18</sup> Like the prospectus example, the costs shown by the Cost Calculator include transactional costs paid directly by a shareholder and ongoing asset-based expenses. In addition, the costs shown by the Cost Calculator include earnings foregone on fees and expenses paid. For example, if an investor paid a \$500 sales charge, and a fund earned a 5% return, the investor would “forego” \$25 (\$500 x .05) in earnings as a result of the sales charge. To use the Cost Calculator, an investor enters the time period that he or she expects to hold the investment, the dollar amount of the investment, and an assumed annual rate of return, as well as the fund’s fees and expenses, which are set forth in the prospectus fee table. In addition, the Commission has produced an on-line brochure explaining the basics of mutual fund investing that includes an extensive discussion of fees and expenses.<sup>19</sup>

### **C. Recommendations for Improving Mutual Fund Expense Disclosure**

#### **1. Continuing Concerns over Investor Awareness**

Despite existing disclosure requirements and educational efforts, the degree to which investors understand mutual fund fees and expenses remains a significant source of concern. As noted above, mutual fund fees are of two types, transactional (*e.g.*, sales loads, redemption fees) and ongoing (*e.g.*, asset-based charges such as management fees and 12b-1 fees). While transactional fees are relatively transparent, ongoing fees are less

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<sup>18</sup> SEC Mutual Fund Cost Calculator <<http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm>> (last modified July 24, 2000).

<sup>19</sup> *Invest Wisely: An Introduction to Mutual Funds* <[www.sec.gov/investor/pubs/inwsmf.htm](http://www.sec.gov/investor/pubs/inwsmf.htm)> (last modified June 2, 2003).

evident because they are deducted from fund assets and are reflected in reduced account balances and expressed as a percentage of net assets in a fund's prospectus.

Surveys have indicated that investors may not understand the nature and effect of these ongoing mutual fund fees. A joint report of the Commission and the Office of the Comptroller of the Currency, for example, found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns.<sup>20</sup> A recent survey found that 75% of respondents could not accurately define a fund expense ratio and 64% did not understand the impact of expenses on fund returns.<sup>21</sup>

## 2. Commission Proposals

In December 2002, the Commission proposed additional disclosure to increase investors' understanding of the expenses that they incur when they invest in a fund, in particular, ongoing expenses. Specifically, the Commission proposed to require mutual funds to disclose in their annual and semi-annual reports to shareholders fund expenses borne by shareholders during the reporting period. Under the Commission's proposal, fund shareholder reports would be required to include: (i) the cost in dollars, associated with an investment of \$10,000, based on the fund's actual expenses and return for the period; and (ii) the cost in dollars, associated with an investment of \$10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.<sup>22</sup> The first figure is intended to permit investors to estimate the actual cost, in dollars, that they

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<sup>20</sup> Securities and Exchange Commission and Office of the Comptroller of the Currency, *Report on the OCC/SEC Survey of Mutual Fund Investors*, at 14-15 (June 26, 1996).

<sup>21</sup> *Investors Need to Bone Up on Bonds and Costs, According to Vanguard/MONEY Investor Literacy Test*, Press Release, BUSINESS WIRE, Sept. 25, 2002.

<sup>22</sup> Investment Company Act Release No. 25870 (Dec. 18, 2002).

bore over the reporting period. The second figure is intended to provide investors with a basis for comparing the level of current period expenses at different funds.

The proposed numerical expense disclosure would be accompanied by a prescribed narrative explanation. The narrative would explain that mutual funds charge both transactional costs and ongoing costs and that the example is intended to help a shareholder understand his or her ongoing costs and to compare those costs with the ongoing costs of investing in other mutual funds. The narrative also would explain the assumptions used in the example, note that the example does not reflect any transactional costs, and caution that the example is useful in comparing ongoing costs but not total costs of different funds.

### 3. Comparison of Commission's Proposal and Alternative Approach

The expense disclosure that the Commission has proposed to require in shareholder reports is designed to increase investors' understanding of the fees that they pay on an ongoing basis for investing in a fund and enhance cost competition among funds. As an alternative to this proposed approach, the Commission also considered the recommendation of the June 2000 GAO Report.<sup>23</sup> This report recommended that the Commission require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement.

The GAO's alternative would have the benefit of providing fund shareholders with personalized information, expressed as a dollar amount, about the fees and expenses that they paid and of presenting that information together with the investor's account value. The Commission's proposed approach, however, effectively permits an investor to

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<sup>23</sup> See June 2000 GAO Report, *supra* note 6.

estimate his or her personalized expenses by multiplying the cost shown for a \$10,000 investment by the investor's account value and, in addition, has significant advantages compared to the GAO's alternative. Disclosure of the dollar amount of fees and expenses paid by investors in a fund's shareholder reports would enable investors to evaluate this information alongside other key information about the fund's operating results, including management's discussion of the fund's performance. In effect, shareholders would be able to evaluate the costs that they pay against the services that they receive. By contrast, expense disclosure in quarterly account statements would not provide an effective context for investors to assess the expenses shown.

In addition, the Commission's proposed disclosure of the cost in dollars associated with an investment of \$10,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year, would provide investors with expense information in a standardized manner that would facilitate comparison of ongoing costs among funds. By contrast, personalized expense disclosure in quarterly account statements would not assist investors in making comparisons among funds because it would be based on different investment amounts and different rates of return.

In addition to the advantages of the Commission's proposed approach in contributing to greater investor understanding of the costs that they pay, this approach also avoids certain costs and logistical complexity that the GAO's alternative likely would entail. Mutual fund expenses are charged against fund assets and are not currently accounted for on an individual account basis. Therefore, implementation of the GAO's recommendation would require system changes to provide for expense accounting on an individual account basis. Moreover, in many cases fund shares are held by

broker-dealers, financial advisers, and other third-party intermediaries, who must prepare accurate and timely customer account statements by integrating data supplied by many unrelated fund groups. In addition to any systems changes necessary for the fund itself, these financial intermediaries also would need to implement system changes in order to calculate and report personalized expense information for each fund held in an account each quarter.

The GAO report recommending personalized expense disclosure had estimated that the cost of this disclosure “might be a few dollars or less per investor” in one-time and annual costs.<sup>24</sup> As of year-end 2001, there were approximately 248 million shareholder accounts invested in funds.<sup>25</sup> At a cost of \$1 per shareholder account, this would translate to a cost of approximately \$248 million. Further, a survey of various industry participants conducted by the Investment Company Institute concluded that the aggregate costs to survey respondents associated with calculating and disclosing the actual dollar amount of fund operating expenses attributable to each investor on quarterly account statements would be \$200.4 million in initial implementation costs and \$65 million in annual, ongoing costs.<sup>26</sup> These costs do not reflect the costs to financial intermediaries, such as broker-dealers, who would be required to prepare account statements for their clients containing this information.

Both the Commission’s proposed approach, requiring disclosure in shareholder reports of period expenses for a standardized \$10,000 investment amount, and the GAO’s

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<sup>24</sup> *Id.* at 97.

<sup>25</sup> Investment Company Institute, *MUTUAL FUND FACT BOOK* 63 (42d ed. 2002).

<sup>26</sup> Investment Company Institute, *ICI SURVEY ON GAO REPORT ON MUTUAL FUND FEES* (Jan. 31, 2001).

suggested approach, requiring personalized expense disclosure on account statements, are designed to improve transparency. While the Commission has not yet made a final decision, the Commission's proposed approach may strike a more appropriate balance between investors' need for more information about fund expenses and the costs and burdens that would be associated with providing this disclosure. The increased transparency of costs resulting from either the Commission's proposal or the GAO's recommended alternative would tend to enhance cost competition among funds. This effect may not, however, be direct or immediate because, under both approaches, the new disclosures would be provided to existing investors. Even if an existing investor is dissatisfied with the level of ongoing costs in a fund, the investor faces disincentives to selling his or her fund shares, *e.g.*, because of tax consequences or sales loads imposed upon a sale of fund shares. Over time, however, the enhanced transparency should have a positive effect on competition among funds and on competition between funds and other financial service providers. In addition, the Commission's proposed approach may have a somewhat greater effect on competition than the GAO's alternative because funds are required to make their shareholder reports available upon request to a prospective investor. Therefore, requiring the inclusion of information on ongoing costs in shareholder reports would add to the information available to prospective investors in making investment decisions.<sup>27</sup>

It is difficult to assess the effects of the Commission's proposed disclosure or the GAO's alternative on competition in the fund industry, in part, because this disclosure

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<sup>27</sup> See Item 1(b)(1) and Instruction 3 to Item 1(b)(1) of Form N-1A (requiring a fund to make reports to shareholders available without charge, upon request, within three business days of receipt of the request).

appears to be unique in the financial services industry. Both the Commission's and the GAO's alternative would go beyond the disclosure provided by other financial service providers by requiring dollar amount disclosure of fees and expenses that are charged indirectly to the customer. The GAO has noted that providers of other financial products and services usually disclose the specific dollar amount of the charges that their customers incur. For example, banks that provide deposit accounts and trust services, advisers that provide investment services and wrap accounts, financing entities that provide mortgages and credit cards, and brokers that charge commissions all disclose the dollar amounts of their fees. Like these service providers, mutual funds provide information about the dollar amount of fees that are charged directly to an account, such as sales loads, redemption fees, and account fees. However, expenses that other service providers indirectly charge as part of the product or service are not disclosed.<sup>28</sup> For example, the holder of a deposit account is not provided any information about the spread between the gross amount earned by the bank on customer funds and the net amount paid out to the customer. This spread is a significant, and largely hidden, cost to the customer.<sup>29</sup> Similarly, mortgage providers add a mark-up to their cost of funds in order to cover the expenses of processing loans. Because other service providers do not provide disclosure of this type, it is difficult to assess its impact on competition.

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<sup>28</sup> June 2000 GAO Report, *supra* note 6, at 70-71.

<sup>29</sup> There is some evidence that competition based on fees has decreased in the banking industry in recent years. A recent study by the Federal Reserve found that from 1997 to 2001, for the various types of checking and savings accounts tracked, monthly fees tended to rise by statistically significant amounts, as did the minimum balances that depositors needed to maintain to avoid the fees. In addition, comparisons of the fees charged by institutions of different sizes in 2001 indicated that, in general, the incidence and levels of fees were higher at larger institutions. Timothy H. Hannan, *Retail Fees of Depository Institutions, 1997-2001*, FEDERAL RESERVE BULLETIN 405 (Sept. 2002).

See the answer to Question 2 below that discusses enhancing disclosure of fund transaction costs, which would promote greater transparency of fund expenses.

**D. Relationship between Expense Disclosure in Prospectus and Proposed Expense Disclosure in Shareholder Reports**

The recent proposal by the Commission is intended to complement the expense disclosure currently required in the fund prospectus. Under current disclosure requirements, prospective investors in a fund receive information in the prospectus about all of the expenses associated with an investment in the fund, including both transactional costs and ongoing expenses. This information is useful to prospective investors in comparing the costs of different funds and making an informed investment decision. If the proposed expense disclosure requirement for shareholder reports is adopted, current investors in a fund would receive information that should help them to understand the costs that they are paying on an ongoing basis and to compare these costs with those of other funds. In addition, as noted above, because funds must make their shareholder reports available to prospective investors upon request, requiring this information on ongoing costs in shareholder reports would also add to the information available to prospective investors. Thus, the information provided would be appropriately tailored for its audience and should not overwhelm investors or detract from their ability to understand other aspects of a mutual fund, such as its performance.

***2. Several witnesses testified about the opacity of portfolio trading costs. Mr. Montgomery stated that his funds obtain an independent review of their trading costs, and make that report available to the funds' board of directors, but not to investors, for competitive reasons. However, he stated that if all funds disclosed such data, they would be "willing and happy to do so." This indicates that trading cost information is certainly relevant as well as calculable, given that at least one fund obtains this data and provides it to its directors. Please provide an analysis of how trading costs could be better disclosed to investors, including an analysis of the relative utility of including commissions and other trading costs in the fund's expense ratio or as a separately disclosed cost item.***

In addition to the costs described above, funds incur portfolio transaction costs (trading costs) when they buy or sell portfolio securities. For many funds, the amount of trading costs incurred during a typical year can be substantial. Although trading costs are taken into account in computing a fund's total return, they are not included as part of a fund's expense ratio. Consequently, some industry observers suggest that funds be required to provide quantitative disclosure of their trading cost as a percentage of total assets.

We agree that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. Quantitative disclosure of trading costs is, however, problematic. Although some trading costs components can be quantified easily and precisely, others can be quantified only with great difficulty, using one of a variety of estimation methods. As a result, we believe that additional numerical disclosure of trading costs would result either in a number that would be comparable and verifiable, but incomplete, or a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund. Below we examine the major issues with respect to disclosure of portfolio transaction costs. First, we describe the different types of trading costs and estimate their magnitude. Next, we explain the current requirements with respect to accounting, disclosure, and information to be provided to fund directors. Finally, we identify and evaluate various proposals for additional quantitative disclosures.

## A. Types of Transaction Costs Incurred by Mutual Funds

Broadly defined, a mutual fund's trading costs are the overall costs of implementing the fund's trading strategy.<sup>30</sup> Trading costs include commissions, spreads, market impact costs and opportunity costs.

Commissions are per share charges that a broker collects to act as agent for a customer in the process of executing and clearing a trade. Commissions are the only type of trading cost that can be measured directly. Measurement is easy because the commission is separately stated as a per share charge on the transaction confirmation and is paid directly from fund assets.<sup>31</sup>

Spread costs are incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The variance from current value is known as the "spread."<sup>32</sup> Spread costs include both an imputed commission on the trade and any market impact cost associated with the trade.

Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security.<sup>33</sup> Stated formally, market impacts are the

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<sup>30</sup> John M.R. Chalmers, Roger M. Edelin, Gregory B. Kadlec, "Mutual Fund Trading Costs," University of Pennsylvania, Rodney L. White Center for Financial Research, Working Paper 027-99, Nov. 2, 1999 at 1.

<sup>31</sup> Stephan A. Berkowitz and Dennis E. Logue, "Transaction Costs: Much ado about everything," JOURNAL OF PORTFOLIO MANAGEMENT (Winter 2001) at 68.

<sup>32</sup> Funds incur spread costs on trades that are made on a principal basis (trades executed from dealer inventory). The "commission" is the unstated increase to the buy price or reduction in the sell price at which the trade is executed. Although these markups and markdowns cannot be directly calculated, they can be estimated, but only with data collected with much difficulty some days after the trade is executed. See Berkowitz and Logue, *supra* note 31 at 68.

<sup>33</sup> The average trade on the New York Stock Exchange and on NASDAQ is approximately 1,700 shares. The average order placed by institutions (including mutual funds) is 44,600 shares, according to an estimate from Plexus, Inc. (Testimony of Wayne H. Wagner at 6). Basic

price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction.<sup>34</sup>

Market impact cost cannot be calculated directly. It can be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade.<sup>35</sup> Impact cost can be reduced by stretching out a trade over a long time period. The benefit of reduced impact cost may be reduced or eliminated by an increase in opportunity cost.

Opportunity cost is the cost of delayed or missed trades. The longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the stock and, by doing so, drive up (or down) the price.<sup>36</sup>

Opportunity cost cannot be measured directly. The joint effect of market impact and opportunity cost can be estimated by comparing market prices at the time that the transaction is conceived to the price at which the transaction was actually executed.

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economics dictate that, if the supply of a good or service is held steady, increased demand drives up the price. Large trades have an impact on price. They “move the market” (drive the price up if the fund is buying; down if the fund is selling.)

<sup>34</sup> See Berkowitz and Logue, *supra* note 31 at 67.

<sup>35</sup> See Berkowitz and Logue *supra* note 31 at 68. Theory suggests comparing the actual price paid or received to what would have prevailed had the order never been placed. In practice, we can observe only actual market prices and the contemporaneous bids and offers to trade.

<sup>36</sup> An opportunity cost is incurred when three conditions hold: (1) the price of a stock rises (falls) after an investor decides to buy (sell) it, but before he or she is actually able to do so; (2) the price change is independent of the investor’s decision; and (3) the price change is “permanent” – *i.e.*, it is caused by the dissemination of information relevant to the valuation of the asset. Other factors may influence the price of an asset, such as temporary liquidity imbalances, but they do not generate opportunity costs. Robert A. Schwartz and Benn Steil, “Controlling Institutional Transactions Costs,” *THE JOURNAL OF PORTFOLIO MANAGEMENT* (Spring 2002) at 43.

Consulting firms, including Plexus, Inc., have developed quantitative tools that attempt to estimate these costs for their clients.<sup>37</sup>

Although estimates of the magnitude of transaction cost and its components vary, the following estimates are representative. For the average stock fund, brokerage costs have been estimated at approximately .30% of net assets<sup>38</sup> and spread costs have been estimated at approximately .50% of net assets.<sup>39</sup> Market impact cost and opportunity cost are more difficult to measure. One study estimates that total transactions costs (including market impact and opportunity costs) for large capitalization equity transactions range from 0.18% to as much as 1% of the principal amount of the transaction.<sup>40</sup> Another study estimates that for institutional investors, under relatively calm market conditions, opportunity costs may amount to 0.20% of value.<sup>41</sup>

In summary, commission costs can be easily determined, but spread, impact, and opportunity costs can only be roughly estimated. As a result, because of the varying factors involved, there is no generally agreed-upon method to calculate transaction costs.

## **B. Accounting Treatment of Transaction Costs**

Under generally accepted accounting principles, portfolio transaction costs are generally capitalized (added to the cost basis of securities purchased or subtracted from

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<sup>37</sup> See Berkowitz and Logue, *supra* note 31 at 70.

<sup>38</sup> Miles Livingston and Edward O'Neal, Mutual Fund Brokerage Commissions, *Journal of Financial Research*, Vol. XIX, No. 2 (Summer 1996) at 280. See, also, Chalmers, Edelin, and Kadlec, *supra* note 30 at 2.

<sup>39</sup> See Chalmers, Edelin and Kadlec, *supra* note 30 at 2.

<sup>40</sup> See Berkowitz and Logue, *supra* note 31 at 67 (citing estimates of commission and market impact costs according to Abel-Noser Benchmarks and the *Plexus Change Commentary*, January 1998; and cost estimates contained in Stephan A. Berkowitz, Dennis E. Logue, and Eugene Noser, "The Total Costs of Transacting on the NYSE," *Journal of Finance*, March 1988, at pp. 97-112).

<sup>41</sup> See Schwartz and Steil, *supra* note 36 at 43-44.

the net proceeds of securities sold) rather than treated as a fund expense.<sup>42</sup> Consequently, each additional dollar of transaction cost produces a one-dollar decrease in total return. One exception (described later in this section) is that certain brokerage service costs are expensed.

Transaction costs are capitalized for two reasons. First, accounting theory considers transaction costs that represent payments for execution and clearing services to be part of the cost of buying or selling a security. Accounting theory dictates that security acquisition and disposition costs be capitalized into the price at which a security is purchased or sold.<sup>43</sup> Second, to the extent that the purchase or sale price includes transaction costs that have been incurred for other reasons, but are difficult to separately identify and strip out of the overall purchase or sales price, accounting theory recognizes that it would be neither feasible nor practical to account for these costs as a fund expense.<sup>44</sup>

Commissions (and spreads) incurred by funds may include payments made under directed brokerage arrangements – arrangements under which a broker agrees to pay certain fund operating expenses and the fund agrees to direct a minimum amount of brokerage to the broker.<sup>45</sup> Conceptually, directed brokerage arrangements are considered

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<sup>42</sup> Federal tax law requires transaction costs to be handled in the same manner. *See* AICPA Audit and Accounting Guide for Investment Companies, paragraph 2.40.

<sup>43</sup> *See* FASB Concept Statement No. 2 and AICPA Audit and Accounting Guide for Investment Companies.

<sup>44</sup> *See* FASB Concept Statement No. 2 and 5. This reasoning may be applied, for example, to spread, market impact, and opportunity costs, as well as to certain “soft dollar” commission costs. *See* Response to question 3 (discussion soft dollars) later in this memorandum.

<sup>45</sup> In a typical directed brokerage arrangement, a fund will earn a credit for a certain level of trading volume placed with one broker. The broker agrees to use that credit to pay a fund’s custody, transfer agent, or other expenses. The fund usually negotiates the terms of the agreement with the custodian or transfer agent, which is paid directly by the broker. Directed brokerage arrangements

to be payments for current services received by the fund and are properly accounted for as a fund expense.<sup>46</sup> The aggregate value of all fund operating expenses paid for by brokers is easily identifiable and measurable, even if the payments cannot be allocated to individual trades. Recognizing this fact, the Commission in 1995 adopted a rule under Regulation S-X that requires a mutual fund to record as an expense the value of services received under a brokerage service arrangement.<sup>47</sup> This requirement also assures that the value of these services is properly reflected in the expense ratios reported by mutual funds in their annual reports to shareholders and their prospectuses.<sup>48</sup> The result is that the portion of commission cost that represents an operating expense of the fund – and is measurable – is reflected in the fund’s expense ratio, fee table, and statement of operations.

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are also referred to as brokerage offset or expense offset arrangements. *See* Investment Company Act Release No. 21221 at 1 (July 21, 1995).

<sup>46</sup> *See* FASB Concept Statement No. 5.

<sup>47</sup> *See* Regulation S-X, Article 6-07(2)(g). In effect, expenses shown in the fund’s statement of operations for transfer agency, custody, and other services paid by brokerage firms on behalf of the fund must be increased by the amount paid by the broker. The fund is allowed to show after total expenses the amount paid by the brokerage firms as an expense offset (income item). This presentation results in a gross-up of expenses in the statement of operations. For purposes of the expense ratio, however, the component of commission/spread costs that should be classified as an expense is so classified in this presentation.

The following example illustrates the required adjustments to the statement of operations:

<b>Expenses</b>	
Management Fee	\$50
[Other direct fund expenses]	48
Custodian Fee [would include 8 paid by brokers]	<u>10</u>
<b>Total Expenses</b>	108
Fees Paid Indirectly	<u>(8)</u>
<b>Net Expenses</b>	100

<sup>48</sup> Brokerage offset amounts may not be netted against fund expenses for purposes of calculating expense ratios.

### **C. Disclosure of Transaction Costs in Prospectuses and SAIs**

All mutual funds (except money market funds) provide investors with information about two items that are related to transaction costs – portfolio turnover rate and dollar amount of brokerage commissions.<sup>49</sup> Funds disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years.<sup>50</sup> Portfolio turnover rate measures the average length of time that a security remains in a fund's portfolio.<sup>51</sup> Portfolio turnover rate is a useful statistic because a fund's transaction costs tend to be highly correlated with its turnover rate, other factors held equal. Thus, by comparing turnover rates, investors can obtain an indication of how transaction costs are likely to vary among different funds. The advantage that turnover rate (an indirect indicator of fund transaction costs) has over the dollar amount of brokerage costs (a more direct measure) is that turnover rate is less affected by the asset size of a fund. For example, a fund with assets of \$1 billion is likely to pay many more dollars of brokerage commissions than a fund with assets of \$100 million, even if their turnover rates are identical.

In addition to providing their portfolio turnover rates, funds are required to disclose in their prospectus whether they may engage in active and frequent trading of portfolio securities to achieve their investment strategies. If so, funds must explain the

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<sup>49</sup> Money market funds purchase and sell securities on a principal basis. Transaction costs for these securities are embedded in the purchase price or sale proceeds and are not separately stated.

<sup>50</sup> See Item 9 of Form N-1A, the form on which a mutual fund registers the offering of its shares under the Securities Act of 1933. Form N-1A includes a description of the information that a fund must provide in its prospectus and statement of additional information.

<sup>51</sup> For example, a fund that has a portfolio turnover rate of 100% holds its securities for one year, on average. A fund with a portfolio turnover rate of 200% holds its securities for six months on average.

tax consequences to shareholders of the increased portfolio turnover, and how the trading costs and tax consequences may affect investment performance.<sup>52</sup>

Funds (with the exception of money market funds) also must disclose the actual dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.<sup>53</sup> Brokerage commission amounts, although they must be interpreted carefully, can nevertheless provide useful information to fund investors. The dollar amounts appear in a fund's statement of additional information (SAI), which, as its name suggests, is a disclosure document that provides information that adds to and supplements the information provided in the prospectus about a fund's policies, procedures and operations.<sup>54</sup> This disclosure informs investors of the magnitude of the fund's overall assets that are expended on commissions.

#### **D. Review of Transaction Costs by Fund Directors**

Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.<sup>55</sup> The transaction costs incurred by a mutual fund are generally reviewed by the fund's board of directors because section 15(c) of the 1940 Act requires a fund's board to request and review such information as may reasonably be

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<sup>52</sup> See Item 4(b), instruction 7 or Form N-1A.

<sup>53</sup> See Item 16(a) of Form N-1A.

<sup>54</sup> All funds are required to provide their SAI to investors upon request. In addition, the SAI of any fund may also be accessed via the Commission's website ([www.sec.gov](http://www.sec.gov)) and frequently on a fund's or a fund sponsor's web site.

<sup>55</sup> See Securities Exchange Act Release No. 23170 (April 23, 1986).

necessary to evaluate the terms of the advisory contract between the adviser and the fund. Research and other services purchased by the adviser with the fund's brokerage bear on the reasonableness of the fund's management fee because the research and other services would otherwise have to be purchased by the adviser itself, resulting in higher expenses and lower profitability for the adviser. Therefore, mutual fund advisers that have soft dollar arrangements must provide their funds' boards with information regarding their soft dollar practices.<sup>56</sup>

#### **E. Proposals for Additional Transaction Cost Disclosure**

During the March 12th hearings, several witnesses testified about the opacity of portfolio trading costs and made suggestions for additional disclosure. Mr. Montgomery, for example, stated that his funds obtain an independent review of their trading costs, and make that report available to the funds' board of directors, but not to investors, for competitive reasons. He stated that if all funds disclosed such data, however, they would be "willing and happy to do so."<sup>57</sup>

In subsequent discussions with the staff, Mr. Montgomery clarified his proposal, indicating that because narrative disclosures would inevitably be complex and technical, his preferred approach would be to require funds to disclose their total transaction costs as a percentage of average net assets.<sup>58</sup> Total transaction costs would be measured by applying the concept of "implementation shortfall" – for each trade, the difference between the price actually paid for the security and the price that existed when the trading

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<sup>56</sup> See Section 15(c) of the 1940 Act. *See also* SEC OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKERS/DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS at 30 (Sept. 22, 1998).

<sup>57</sup> Testimony of John Montgomery at 5.

<sup>58</sup> Telephone conversation with John Montgomery (April 8, 2003).

decision was made.<sup>59</sup> Mr. Montgomery believes that the fund industry could reach consensus on how to estimate this number.<sup>60</sup>

Other suggestions made during the hearings include:

- Add to the fee table example an estimate of transaction costs (including commissions, spreads, market impact costs).<sup>61</sup>
- Disclose overall transactions costs, either as a numerical estimate or in categories such as Very High, High, Average, Low and Very Low Cost.<sup>62</sup>

#### **F. Analysis of Proposals for Additional Transaction Cost Disclosure**

Some commentators have proposed that mutual fund transaction costs be accounted for as an expense item in fund financial statements and included as an expense in fund expense ratios and fee tables.

For commissions, this would be relatively easy. As previously indicated, the per share commission appears on the confirmation of each transaction and funds already report in their SAIs the aggregate dollar amounts of commissions paid.

The staff has considered the matter informally on several occasions and continues to believe that it would be inappropriate to account for commissions as a fund expense

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<sup>59</sup> The term “implementation shortfall” was introduced by Perold in 1988. Implementation shortfall is defined as a measure of the degree to which execution, market impact and opportunity costs prevent the investor from taking advantage of his or her stock selection skills. Perold, Andre F. *The Implementation Shortfall: Paper vs. Reality*, JOURNAL OF PORTFOLIO MANAGEMENT (Spring 1988) at 5-6. Leinwebber illustrates the concept by noting that from 1979 to 1991 stocks classified as “Group 1” by Value Line had an annualized return of 26.3% while the Value Line mutual fund that contained the same stocks returned only 16.1%. The difference between the paper return and the actual portfolio return is the cost of trading. David J. Leinwebber, *Using Information from Trading in Trading and Portfolio Management*, 4 JOURNAL OF INVESTING, No. 1 (1995) at 40.

<sup>60</sup> Telephone conversation with John Montgomery (April 8, 2003) and testimony of John Montgomery at 4.

<sup>61</sup> Testimony of John Bogle at 11.

<sup>62</sup> Testimony of Wayne H. Wagner at 3.

unless spreads, and possibly impact and opportunity costs, were treated in a similar manner. Commissions and spreads, for example, pay for similar services. Expensing commissions and not spreads would cause funds that execute their trades on an agency basis (and pay commissions) to report higher expenses than funds that execute their trades on a principal basis (and incur the cost of the bid-asked spread).<sup>63</sup> This disparity could encourage funds to shift their trading activity in listed securities from exchanges to Nasdaq in order to appear less costly, even if better execution prices could be obtained on an exchange.

Furthermore, an expense number that included commissions and spreads, but not market impact and opportunity costs would still be problematic because funds that are more costly from an overall transaction cost standpoint might appear to be less costly if only commission and spread costs were disclosed.<sup>64</sup> An investor who evaluates whether a fund is getting best execution needs to consider not only commissions and spreads, but also the prices at which security purchases and sales are executed. Transactions with low commissions or spreads and a less favorable execution price may be less beneficial than transactions with higher commissions or spreads and more favorable execution prices.

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<sup>63</sup> The Commission has recognized that money managers opting for certain riskless principal transactions on Nasdaq would now be informed of the entire amount of a market maker's charge for effecting the trade. *See* Securities Exchange Act Release No. 45194 (Dec. 27, 2001). In this release, the Commission also recognized that fees on other riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction), and that fees on traditional principal transactions also can include an undisclosed fee based on some portion of the spread.

<sup>64</sup> Testimony of Wayne H. Wagner at 5 and John Bogle at 4.

This brings us to the issue of whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe that the answer is “no.”

Consultants and academics derive transaction cost estimates that include spreads and market impact costs by using a variety of algorithms to compare the actual price that was paid in each transaction with the market price that prevailed at some time before<sup>65</sup> or after<sup>66</sup> the transaction was completed. Perhaps the most all-inclusive way to measure transaction cost is “implementation shortfall” – the approach recommended by Mr. Montgomery. Implementation shortfall measures transaction cost as the difference between the price of each trade that was actually made and the price that prevailed in the market when each decision to trade was made.

Although the transaction cost estimates described above may provide valuable information to funds, their boards of directors, and researchers, we believe that these estimates would not provide an appropriate basis for reporting transaction costs as an expense in fund financial statements, or reporting these costs separately in fund disclosure documents.

With respect to the before trade and after trade methods, a common standard would need to be chosen from among the wide variety of estimation techniques that are

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<sup>65</sup> A “before trade” measure compares the actual price of each trade with the price that prevailed in the market at the time that the decision to trade was made. *See* Perold, *supra* note 59 at 8.

<sup>66</sup> In an “after trade” measure, the market price might be today’s closing price, tomorrow’s closing price, some other price in effect after the fund completed the trade, the average of the high and the low for the day, or a weighted average of all prices at which market participants transacted on that day. *See* Perold, *supra* note 59 at 7.

used, opportunity costs would remain unaccounted for, and some measures in this category would be vulnerable to being “gamed.”<sup>67</sup>

The advantages of the implementation shortfall method are that it includes all trading costs and may be less vulnerable to being gamed. However, because implementation shortfall compares prices of actual trades to prices in effect when trading decisions were made, the practical difficulties of mandating its use by all funds are daunting. Funds would need to collect and analyze enormous quantities of information throughout the trading process – from the portfolio manager, the trader, and the broker, whenever each makes a decision that affects the outcome of the trade – including the time, price, and quantity outcomes for each decision in the process of filling an order.<sup>68</sup> Objective and verifiable criteria would need to be developed for determining when a trading decision has actually been made, determining when the decision has been modified or revised, and selecting the figure that represents a security’s market price at each of these times. These criteria would need to be mandated for use by all funds. Determining the extent to which the fund’s actual trading activity has varied from its intention would be difficult, even if additional record keeping requirements were

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<sup>67</sup> For example, because a before trade measure compares the actual price of each trade with the market price in effect when the decision to trade was made, the market price is known in advance. A trader working on behalf of a fund could “manufacture” low transaction costs if, after each decision to trade is made, the trader would wait to take action on the order list, implement only the buy orders for which prices have fallen since the receipt of the order, implement only the sell orders for which the prices have risen, and dismiss the rest of the orders as “too expensive” to execute. See Perold, *supra* note 59 at 7-8.

<sup>68</sup> See Berkowitz and Logue, *supra* note 31 at 70-73.

mandated concerning the motivations for the trade, such as investment objective, target price, and time horizon.<sup>69</sup>

To summarize, our view is that although proposals to quantify transaction costs are attractive in theory, it is difficult to see how they could be feasible. Even if a detailed regulatory regime were imposed on the operational procedures that funds use to effect portfolio transactions, the resulting estimates of transaction costs would appear to lack the attributes of uniformity, reliability and verifiability that are the hallmarks for recording operations results in financial statements.

One commentator suggested transaction costs could be disclosed in terms of rated categories, instead of as part of the expense ratio or as a stand-alone ratio. The commentator suggested funds would categorize their trading costs as either very high, high, average, low or very low. The commentator acknowledged this disclosure might be a rough estimate, but a “rough estimate was better than no estimate at all.”<sup>70</sup> Although we agree that a rough estimate might be better than nothing, each fund would still have to be compared to an industry standard. In order for such a comparison to be made, a transaction cost measure would still have to be developed. It would have to be determined whether, for example, any comparison should be against other funds generally or only against similar funds. After all, the transaction costs of an equity fund are likely not comparable to a fixed-income or money market fund. Therefore, comparing a high rating on an equity fund to a low rating on a fixed-income fund might prove confusing and misleading to investors. If the Commission were to set the standard

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<sup>69</sup> Donald B. Keim and Ananth Madhavan, *The Cost of Institutional Equity Trades*, FINANCIAL ANALYSTS JOURNAL (July/Aug. 1998) at 54-55.

<sup>70</sup> Testimony of John Bogle at 11.

for comparison, the Commission would be put in the unusual position of passing judgment on a fund's cost structure. The suggestion is theoretically acceptable but practically difficult to implement.

Although each of the suggestions outlined above has merit, we believe as a practical matter that it would be enormously difficult to implement any of the suggestions. Nonetheless, we agree that investors would benefit from better, more understandable disclosure of transaction costs. We therefore will consider whether to recommend that the Commission issue a concept release to elicit views on the suggestions outlined above, and to solicit additional suggestions. The goal of such a release would be to obtain comment on whether it is possible to construct a transaction cost measure that would be comparable, verifiable and complete, yet not unduly burdensome to funds and their service providers.

Investors currently get disclosure on transaction costs from several sources in the prospectus, SAI, and annual report; however, the issue remains whether investors understand the information that is being disclosed. Accordingly, the staff intends to examine several approaches for improving the current disclosure of transaction costs to make the information more understandable to the average investor.

One approach we will consider is to require funds to give greater prominence to the portfolio turnover ratio. Portfolio turnover can be calculated easily by all funds. The ratio is simple and easy to understand and readily comparable among funds. The ratio is a good proxy for costs because the turnover rate is highly correlated with transaction costs. We recognize, however, the imprecision of using portfolio turnover as a means of evaluating transaction costs. It is possible that two funds could have very similar

turnover ratios, but have vastly different transaction costs. For example, a foreign fund may incur high transaction costs per trade and a domestic fund with the same turnover may pay significantly lower transaction costs per trade. Even funds that may have similar investment styles could pay significantly different transaction costs per trade, depending, for example, on the size of the fund. Notwithstanding these drawbacks, we believe that the advantages of being able to easily calculate, understand, and compare portfolio turnover rates outweigh any imprecision in its correlation to transaction costs. Arguably, providing additional prominence to portfolio turnover might be as good as requiring funds to categorize themselves in a transaction cost category (*e.g.*, “very high,” “high,” “average,” etc.). Both types of disclosure are somewhat inexact, especially if the “cost” category is based upon a rough estimate of transaction costs.

Another approach the staff will consider is whether to require a discussion of transaction costs and portfolio turnover in the prospectus. Currently, funds are required to discuss the impact of active and frequent portfolio trading, which results in a higher portfolio turnover ratio, if it is a principal investment strategy. The Commission could require that all funds discuss the impact that their management style would have on portfolio turnover. Funds also could be required to discuss the impact on portfolio transaction costs by: trading in various types of securities in which the fund will invest; markets in which they will invest (*e.g.*, on an exchange or through over-the-counter transactions, or in foreign or domestic markets); and the portfolio management strategies that a fund’s adviser will employ. In addition, the Commission could require a fund to disclose the portfolio turnover rate that the fund would not expect to exceed.

We also will consider whether the information on brokerage costs included in the statement of additional information should be moved to the fund prospectus and prominently displayed with the portfolio turnover information to give shareholders a more complete understanding of the underlying transaction costs of the fund. In addition, we could consider whether some form of average commission rate per share disclosure<sup>71</sup> should be reinstated, with appropriate revisions to make it more meaningful than the previously eliminated disclosures of such information in the fund's financial highlights table.

In conclusion, we believe that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. Quantitative disclosure of fund commission costs would result in a number that would be comparable and verifiable, but incomplete. Disclosure of a more all-inclusive estimate of transaction costs would result in a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary from fund to fund. As outlined above, we intend to examine whether steps can be recommended to the Commission to improve the current disclosure of transaction costs in order to make the information more understandable to the average investor.

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<sup>71</sup> The Commission in 1995 amended Form N-1A to require funds to disclose in the financial highlights table their average commission rate per share. *See* Investment Company Act Release No. 21221 (July 21, 1995). This amount was calculated by dividing the total dollar amount of commissions paid during the fiscal year by the total number of shares purchased and sold during the fiscal year for which commissions were charged. In 1998 the Commission eliminated this requirement in the belief that the fund prospectus is not the most appropriate document through which to make this information public. *See* Investment Company Act Release No. 23064, (March 13, 1998). The Commission noted that industry analysts had informed the staff that average commission rate information is only of marginal benefit to them and to typical fund investors, and that the analysts support the view that these rates are technical information that typical investors are unable to understand.

**3. Mr. Montgomery stated that “apart from affiliated brokerage and directed brokerage, the practice of soft dollar commissions is one of the worst examples of undisclosed conflicts of interest in the mutual fund industry.” Please discuss how soft dollar arrangements create undisclosed conflicts of interest and whether enhanced transparency and disclosure of actual execution costs would benefit investors.**

The term “soft dollars”<sup>72</sup> typically refers to arrangements under which an investment adviser directs client brokerage transactions to a broker and, in exchange, obtains research products or services in addition to brokerage services from or through a broker. We agree that soft dollar arrangements may involve the potential for conflicts of interest between a fund and its investment adviser. Soft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser’s soft dollar commitments to brokers.<sup>73</sup>

These types of conflicts, however, are generally managed by fund boards of directors. Fund independent directors are in a better position to monitor the adviser’s direction of the fund’s brokerage than are fund investors.<sup>74</sup> Accordingly, the Commission

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<sup>72</sup> Section 28(e) of the Securities Exchange Act of 1934 permits money managers to obtain research with soft dollars without breaching their fiduciary duty to their clients as described below.

<sup>73</sup> Recent studies by securities regulators in the United Kingdom have drawn similar conclusions. “[S]oft commission arrangements . . . create powerful incentives that complicate the principal-agent relationship between a fund manager and its clients. The conflicts of interest involved raise doubts about the ability of fund managers both to obtain value for money when spending their clients’ funds on acquiring additional broker services, and to trade for their clients on the most advantageous terms—that is to deliver best execution.” FINANCIAL SERVICES AUTHORITY, BUNDLED BROKERAGE AND SOFT COMMISSIONS §2.11 (Apr. 2003) (“FSA Report”). See also Paul Myers, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (March 6, 2001).

<sup>74</sup> Moreover, directors must assess the fund adviser’s use of soft dollars when evaluating the amount of the adviser’s compensation. See Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Release No. 20614 (Oct. 13, 1994) at n.38. See also Securities Exchange Act Release No. 23170 (Apr. 23, 1986) at nn.40-43 and accompanying text (“Disinterested directors are required to ‘exercise informed discretion’, and the responsibility for

has not required fund prospectuses to disclose specific information about the use of soft dollars and the Commission has made clear the responsibilities of fund independent directors in connection with their oversight of the allocation of fund brokerage.<sup>75</sup>

Arguments in favor of improved transparency of fund brokerage are usually framed in terms of improving the information that investors have about fund “expenses” rather than providing investors with specific information about conflicts of the fund adviser.<sup>76</sup> For example, as discussed above, shareholders are provided with the fund’s portfolio turnover rate, from which they can deduce the extent to which the fund incurs securities trading costs. A relatively high level of turnover, however, may result from a management strategy that requires frequent trading, rather from the need to acquire soft dollar benefits with the brokerage. Thus, greater transparency of brokerage costs is unlikely to help an investor evaluate a fund adviser’s conflicts in using soft dollars.

We are nonetheless concerned about the growth of soft dollar arrangements and the conflicts they may present to money managers, including fund advisers. Many soft dollar arrangements are protected by section 28(e) of the Securities Exchange Act of 1934 (the “1934 Act”). Section 28(e) creates a safe harbor permitting money managers (including fund advisers) to pay more than the lowest available commission if the money manager determines in good faith that the amount of the commission is reasonable in

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keeping the independent directors informed lies with management, *i.e.*, the investment adviser and interested directors.”).

<sup>75</sup> Even though most investors may not find this information important, the Commission believes that those investors who desire to know more about brokerage allocation practices should have access to the information. Funds are therefore required to make brokerage information available, upon request, in their Statements of Additional Information. *See* Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 13436 (Aug. 12, 1983)

<sup>76</sup> *See, e.g.*, March 2003 GAO Report, *supra* note 6 at 18.

relation to the value of the brokerage and research services provided. This section only excludes paying more than the lowest available commission and does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws or from allegations, for example, that he churned an account, failed to seek the best price, or failed to make required disclosures. The effect of section 28(e) is to suspend the application of otherwise applicable law, including fiduciary principles, and to shift responsibility to advisory clients (including fund boards) to supervise their money manager's use of soft dollars and the resulting conflicts of interest, based on disclosure that the clients receive from the money manager.<sup>77</sup>

All discretionary money managers can use the safe harbor provided by section 28(e) to obtain research with soft dollars from clients' brokerage, whether the clients are mutual funds, individuals, pension funds or hedge funds. One key difference is that an adviser to a mutual fund (*e.g.*, a registered investment company)<sup>78</sup> or a pension fund<sup>79</sup> cannot receive compensation (including research) pursuant to a soft dollar arrangement involving the fund outside of the safe harbor provided by section 28(e). Advisers are not subject to this constraint with respect to other types of clients, including individuals and

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<sup>77</sup> Section 28(e)(2) of the 1934 Act authorizes the Commission to require disclosure of an adviser's soft dollar policies and practices.

<sup>78</sup> Section 17(e)(1) of the 1940 Act provides that it is unlawful for the fund adviser "acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered investment company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; . . ."

<sup>79</sup> The Department of Labor has interpreted the Employee Retirement Income Security Act of 1974 (ERISA) to prohibit an adviser to an employee pension or benefit plan subject to ERISA from obtaining soft dollar benefits from allocating plan brokerage, except within the section 28(e) safe harbor. Department of Labor, Technical Release 86-1, (May 22, 1986) app. III.

hedge funds.<sup>80</sup> Our recent examination sweep of hedge funds found that a number of hedge fund advisers often use soft dollars to pay for services that are clearly outside of the safe harbor, including payment for office operations.

Advisory clients receive information about their adviser's soft dollar practices in the adviser's disclosure statement or "brochure," which the client receives at the beginning of the advisory relationship.<sup>81</sup> The adviser must disclose factors that it uses to select brokers for client transactions, the types of research or services that the adviser receives in return for brokerage, whether the adviser "pays up" for research, and whether the adviser may use one client's brokerage to obtain research that benefits other clients.

The Commission has proposed to improve the quality of information provided to clients in Form ADV. The staff expects to recommend that the Commission adopt the proposal soon.<sup>82</sup> Disclosure, however, has its limitations. Because advisers necessarily have an interest in maintaining their flexibility to serve their clients, disclosure brochures thus often describe a wide range of research and other services that the advisers might obtain with client brokerage. Although the disclosure may satisfy or even exceed the adviser's legal requirements, most clients may find it very difficult to evaluate soft dollar practices based on (sometimes lengthy) narrative discussions of practices that may or may not occur in the future. Moreover, many clients may not even understand the best-

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<sup>80</sup> An adviser may, however, be subject to some other specific restriction under state or federal law that is unique to a particular client. Our response addresses only the most common restrictions imposed on money managers.

<sup>81</sup> Rule 204-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). It should be noted that Form ADV is not required to be provided to fund shareholders.

<sup>82</sup> Investment Advisers Act Release No. 1862 (Apr. 5, 2000).

written disclosure, having hired an adviser because they do not have the expertise, time or inclination to worry about matters such as soft dollars.

Without ongoing quantitative information about soft dollar practices and their effect on brokerage decisions and their costs (both implicit and explicit), even the most knowledgeable advisory clients (including fund boards of directors and pension plan officials) will find it difficult to effectively supervise their advisers' use of brokerage. The Commission twice has proposed to require advisers to give clients periodic quantitative information about the use of client brokerage and the research and services advisers obtain from brokers.<sup>83</sup> Both times the rules were not adopted because of intractable problems in valuing the research and services that advisers receive for soft dollars, tracing the allocation of those benefits to clients' accounts, and quantifying the effect of the benefits on the accounts' performance.<sup>84</sup>

We are not sanguine that enhanced disclosure alone will provide sufficient transparency to permit advisory clients to supervise their money managers' use of soft dollars. Even if the measurement problems were solved so that advisers could provide quantitative information to clients, we think it is unlikely that most clients would (or could) become sufficiently involved in brokerage decisions to fully protect their interests. Moreover, to the extent that some clients do become involved and effectively restrict their advisers' use of soft dollars, the advisers may compensate by increasing their use of other clients' brokerage to obtain research and other soft dollar benefits.

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<sup>83</sup> As discussed earlier, section 28(e)(2) of the 1934 Act authorizes the Commission to require this disclosure.

<sup>84</sup> Securities Exchange Act Release No. 13024 (Nov. 30, 1976); Investment Advisers Act Release No. 1469 (Feb. 14, 1995).

We note that section 28(e) was enacted in 1975 to protect brokers' practice of providing discounts on brokerage commissions that had been fixed pursuant to exchange and Commission rules.<sup>85</sup> After negotiated commissions were permitted, money managers and broker-dealers expressed concern that causing a client to pay a commission in excess of the lowest rate available for services that benefited the client only indirectly would be considered a breach of the advisers' fiduciary duty.<sup>86</sup> While we intend to continue our efforts to improve disclosure and expect to ask the Commission to propose changes to the record-keeping rule under the Advisers Act to require advisers to keep better records of the products and services they receive for soft dollars, we believe that after 28 years it may be appropriate to reconsider section 28(e) or, alternatively, to amend the provision to narrow the scope of this safe harbor.<sup>87</sup>

***4. Please discuss whether disclosing the structure of portfolio manager compensation might benefit investors.***

Mutual funds typically are externally managed by an investment adviser, to which they pay an advisory fee from fund assets. The investment adviser in turn employs the individuals who act as portfolio managers. Commission rules require a fund to provide disclosure of the amount of the advisory fee paid to the investment adviser in the fee table

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<sup>85</sup> P.L. No 94-29, 89 Stat. 97, 10707.

<sup>86</sup> The concern over "paying up" arose in part out of litigation relating to whether advisers to investment companies had an obligation to recapture commission rebates for the benefit of their investment company clients. See *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977); *Arthur Lipper Corp. v. Securities and Exchange Commission*, 547 F.2d 171 (2d Cir. 1976); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); and *Moses v. Burgin*, 445 F. 2d 369 (1<sup>st</sup> Cir.), *cert. denied*, 404 U.S. 994 (1971).

<sup>87</sup> The FSA Report recommended that British money managers not be able to purchase with client commissions "goods and services for which demand is reasonably predictable." FSA Report at 4.4. Another approach might be to preclude money managers from paying for subscriptions, data feeds, pricing services and other services that more closely resemble overhead items.

in the fund's prospectus.<sup>88</sup> In addition, the prospectus must include a description of the investment adviser's compensation, including the aggregate fee paid to the adviser for the most recent fiscal year as a percentage of average net assets.<sup>89</sup> If the fee is not based on a percentage of average net assets, *e.g.*, if the adviser receives a performance-based fee, the prospectus also is required to describe the basis of the adviser's compensation.<sup>90</sup> Further, a fund is required to provide disclosure in its SAI regarding the method of calculating the advisory fee payable by the fund, including the total dollar amounts that the fund paid to the investment adviser under the investment advisory contract for the last three fiscal years.<sup>91</sup>

Some have suggested that operating companies are held to a higher standard of disclosure than mutual funds because operating companies are required to disclose manager compensation,<sup>92</sup> while funds are not.<sup>93</sup> The most direct mutual fund analogue to the compensation of an operating company's managers, however, is the compensation of the investment adviser that, as described above, is required to be fully disclosed. The advisory fee is the amount paid by fund shareholders for portfolio management services. Individual portfolio managers are employees of the investment adviser and are compensated by the adviser.

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<sup>88</sup> Item 3 and Instruction 3(a) to Item 3 of Form N-1A.

<sup>89</sup> Item 6(a)(1)(ii)(A) of Form N-1A.

<sup>90</sup> Item 6(a)(1)(ii)(B) of Form N-1A.

<sup>91</sup> Item 15(a)(3) of Form N-1A.

<sup>92</sup> Item 402 of Regulation S-K (requiring disclosure of all compensation paid to certain named executive officers, including the registrant's chief executive officer and four most highly compensated officers other than the chief executive officer).

<sup>93</sup> *See, e.g.*, Russel Kinnel, *Fund Investors Should Demand Equality*, MORNINGSTAR.COM, August 6, 2001.

Disclosure regarding the structure of an individual portfolio manager's compensation might, nonetheless, be useful in supplementing existing disclosure of the advisory fee. It could provide fund shareholders with information that would be helpful in assessing the incentives of the individuals who are managing the fund. For example, disclosure that a manager is compensated based on the fund's performance for a particular period, *e.g.*, 3 months, 1 year, or 5 years, may shed light on the manager's incentives to maximize short-term or long-term performance. Similarly, disclosure of whether a portfolio manager's compensation is based on a fund's pre-tax or after-tax returns may be useful in assessing whether a fund is an appropriate investment for a taxable or tax-deferred account.

There are some practical issues related to requiring disclosure of the compensation structure of a portfolio manager, which could make the disclosure fairly lengthy and complex. These issues would need to be addressed in designing any such disclosure requirements. First, many funds are not managed by a single portfolio manager, but instead are managed by teams or committees. In such cases, it may be difficult to determine which team members' compensation should be disclosed – *e.g.*, the entire team, certain lead managers, any manager whose compensation depends on fund performance. Further, if compensation disclosure is provided for multiple management team or committee members, the disclosure may become long and complicated. Second, in situations where a portfolio manager is compensated for managing multiple portfolios, perhaps including both mutual funds and hedge funds, complete disclosure of the manager's incentives may require disclosure of the manager's compensation structure

with respect to each portfolio. This would also tend to make the disclosure longer and more complicated.

***5. In light of the fact that fund directors' holdings of fund shares is disclosed to investors, it would seem to make sense that the same information about portfolio managers' holdings of fund shares would be just as important to disclose to investors. Please discuss whether investors would benefit from having the same information about portfolio managers.***

In January 2001, as part of rule amendments designed to enhance the independence and effectiveness of boards of directors of funds and to better enable investors to assess the independence of those directors, the Commission adopted rules requiring disclosure of the dollar range of each director's ownership in each fund that he or she oversees.<sup>94</sup> In adopting this requirement, the Commission noted that a director's ownership in a particular fund provides the most direct indication of the director's alignment with the interests of shareholders in that fund.<sup>95</sup> The Commission also noted, however, that a director could have many reasons for not holding shares of a specific fund, *e.g.*, that the fund's investment objectives do not match those of the director. Thus, the Commission also required disclosure of a director's aggregate ownership in any funds that a director oversees within a fund family, in part to prevent any inappropriate negative inference that a fund shareholder could draw from the fact that the director does not hold shares of a particular fund.

While we note that fund portfolio managers have incentives to manage a fund's portfolio to achieve a fund's investment objective (*i.e.*, retaining their jobs), disclosure of a portfolio manager's holdings of fund shares could provide some indication of his or her

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<sup>94</sup> Investment Company Act Release No. 24816 (Jan. 2, 2001); Item 22(b)(5) of Schedule 14A ; Item 13(b)(4) of Form N-1A; Item 18.7 of Form N-2; Item 20(f) of Form N-3.

<sup>95</sup> Investment Company Act Release No. 24816 (Jan. 2, 2001).

alignment with the interests of fund shareholders. This disclosure also could provide investors with some insight into the level of confidence that a manager has in the investment strategy of the fund.

For a portfolio manager, however, compensation structure is probably a more direct indicator of alignment with the interests of fund shareholders. If a manager's compensation is tied to his or her success in managing one or a group of funds, then understanding his or her compensation structure would probably be the best guide to understanding whether the manager's interests are aligned with those of fund shareholders. Compensation structure could shed light on issues such as a manager's incentives to manage with a short- or long-term horizon, to maximize pre- or after-tax returns, and to focus on each of the various funds that he or she manages. Compensation structure, as a measure of alignment, does not suffer from the ambiguities of fund holdings disclosure. Portfolio managers, like directors, may have a number of reasons, other than lack of confidence in the fund's investment strategy, for not holding shares of a particular fund.

We note that, as is the case with disclosure of a portfolio manager's compensation, there are some practical issues related to requiring disclosure of managers' holdings of fund shares where a fund is managed by a team or committee. In such a case, it may be difficult to determine which team members' holdings should be disclosed – *e.g.*, the entire team, certain lead managers. Further, if fund holdings disclosure is provided for multiple management team or committee members, the disclosure may become long and complicated.

***6. Please provide an analysis of the current definition of independent (“disinterested”) directors under the Investment Company Act of 1940,***

*including a discussion of the adequacy of that definition. Additionally, please discuss whether directors are adequately serving fund shareholders' interests, including oversight of fund fees. In particular, please address the impact of requiring the chairman of the board of a fund to be disinterested.*

#### **A. Definition of Interested Person**

The 1940 Act gives fund boards a central role in protecting the interests of fund investors. Section 10(a) of the 1940 Act requires that at least 40% of the members of a fund's board consist of independent directors, i.e., persons who are not "interested persons."<sup>96</sup> In 2001, the Commission amended ten of its exemptive rules to require that funds relying on them have a board a majority of whose members are not "interested persons" of the fund or its adviser.<sup>97</sup> The Commission has indicated that a fund board that has at least a majority of independent directors is better equipped to perform its responsibilities of protecting the fund and its shareholders. By virtue of its independence and its ability to act without the approval of the investment adviser (whose employees often serve as interested or "inside" directors on fund boards), such a board is better able to exert a strong and independent influence over management, particularly in areas where the fund's interests conflict with those of the adviser, such as in the area of management fees. Today, most fund boards have a majority of "independent directors."

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<sup>96</sup> The original Senate bill that culminated in the 1940 Act would have required a majority of a fund's directors to be independent from management. *See* S. 3580, 76th Cong. § 10(a) (1940). That requirement was changed to 40% out of concern that a board with an independent majority would repudiate the recommendations of the investment adviser. *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109-110 (1940) (testimony of David Schenker).* In 1970, Congress amended the 1940 Act to require that independent directors not be "interested persons" under new section 2(a)(19). *See* S. Rep. No. 91-184, at 32-33 (1969).

<sup>97</sup> Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) (amending rules 10f-3, 12b-1, 15a-4, 17a-7, 17a-8, 17d-1, 17e-1, 17g-1, 18f-3, and 23c-3 under the 1940 Act).

Section 2(a)(19) of the 1940 Act defines the term “interested person” to include the fund’s investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter.<sup>98</sup> It also encompasses a broader category of persons having business relationships with the fund or its investment adviser, including certain broker-dealers and persons who have served as counsel to the fund, its investment adviser, or principal underwriter within the last two fiscal years of the fund.<sup>99</sup> Finally, section 2(a)(19) provides the Commission authority to issue an order deeming a natural person to be an “interested person” as a result of certain material business relationships occurring within the last two fiscal years of the fund.<sup>100</sup>

We would ask Congress to consider a revision to section 2(a)(19). We suggest that the Commission be given rulemaking authority to fill gaps in the statute that have permitted persons to serve as independent directors despite relationships that suggest a lack of independence from fund management. For example, the statute permits a former executive of the fund’s adviser to serve as an independent director two years after the person has retired from his position. This permits an adviser to use board positions as a retirement benefit for its employees. The statute also permits relatives of fund managers to serve as independent directors as long as they are not members of the “immediate

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<sup>98</sup> Section 2(a)(19)(A)(i)-(iii).

<sup>99</sup> Section 2(a)(19)(A)(iv)-(vi).

<sup>100</sup> Section 2(a)(19)(vii). In 1999 the Commission published a release discussing, among other things, the types of professional and business relationships that may be considered to be material for purposes of section 2(a)(19). Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999).

family” of affiliated persons of the fund. In one case, the uncle of the fund’s portfolio manager served as an independent director of the fund.<sup>101</sup>

## **B. Adequacy of Fund Boards**

It is difficult to draw any generalized conclusions about the adequacy of fund boards. However, we believe that one of the principal reasons the mutual fund industry has avoided the scandals that have plagued other segments of the securities industry is the presence of independent directors. In our experience there are many excellent boards and some that fall far short of the mark.<sup>102</sup> In the past few years, the Commission has been actively promoting effective governance of funds. In 1999, the Commission held a Roundtable discussion on the role of independent directors of funds.<sup>103</sup> That Roundtable discussion led to the adoption by the Commission in 2001 of amendments to a number of exemptive rules designed to strengthen fund boards in dealing with management.<sup>104</sup> The rule amendments require that, for funds relying on the exemptive rules: (i) independent directors constitute a majority of the board; (ii) independent directors select and nominate other independent directors; and (iii) any legal counsel for the independent directors meet certain requirements that qualify them as an “independent counsel.” Most funds, as a

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<sup>101</sup> See Aaron Lucchetti, *SEC Backs Uncle’s Role as Director*, Wall St. J., Nov. 11, 1999 at C1.

<sup>102</sup> See, e.g., In the Matter of James A. Merriam, Investment Company Act Release No. 21062 (May 11, 1995) (investment company’s board failed to meet for two years); *SEC v. Boca Raton Capital Corp.*, Litigation Release No. 14294 (Oct. 11, 1994) (at least five out of six directors were interested persons of investment company); *SEC v. Forty Four Management, Ltd.*, Litigation Release No. 11717 (Apr. 28, 1988) (directors caused investment company to pay expenses of litigation in which the investment company was not interested); *SEC v. American Birthright Trust Management Company, Inc.*, Litigation Release No. 9266 (Dec. 30, 1980) (directors approved advisory contracts without requesting information reasonably necessary to evaluate the contracts).

<sup>103</sup> Transcripts from the Roundtable are available on the Commission’s internet website at [www.sec.gov/divisions/investment/roundtable/iicdtoc.shtml](http://www.sec.gov/divisions/investment/roundtable/iicdtoc.shtml).

<sup>104</sup> Role of Independent Directors of Investment Companies, *supra* note 97.

practical matter, must rely on at least one of the exemptive rules and thus are subject to these amendments. We believe that the amendments, together with the attention the Roundtable discussion and the rulemaking proceeding received, have led to stronger, more independent, fund boards, which are today better equipped to deal with conflicts that arise in the management of funds, including the oversight of fund expenses.

However, the staff notes that Congress could consider replacing the 1940 Act's current general standard that 40% of a fund's board be independent with the requirement in the Commission exemptive rules that a majority of a fund's board be independent, which would codify the standard currently employed by most funds.<sup>105</sup> The majority requirement would permit the independent directors to control the "corporate machinery," *i.e.*, to elect officers of the fund, call meetings, solicit proxies and take other actions without the consent of the investment adviser. This statutory change would ensure that all fund boards have the benefits of a board with an independent majority.

Mutual fund directors must continue to exercise vigilance in monitoring the fees and expenses of the funds they oversee, and ensure that an appropriate portion of the cost savings achievable from any economies of scale are passed along to fund shareholders. In our inspections of mutual funds, we find that most boards of directors are obtaining the necessary information to evaluate the various types of fund fees and expenses, as well as costs not reflected in a fund's expense ratio, such as portfolio transaction costs.<sup>106</sup> Some boards obtain material prepared by outside experts that is used to compare a fund's

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<sup>105</sup> See Section 10(a) of the 1940 Act.

<sup>106</sup> The staff is considering whether record-keeping requirements in this area would facilitate the staff's review of whether fund directors and advisers are fulfilling their obligations under section 15(c) of the 1940 Act.

performance, fee structure and expenses to funds of comparable size and investment objective. Independent directors also may rely on independent counsel for advice and information in connection with the evaluation of management and other service contracts. Fund directors then exercise their business judgment as to whether they view these fees as reasonable and consistent with statutory standards. See the response to Question 9 below regarding statutory standards for approval of investment advisory contracts.

### **C. Independent Chairman**

Several industry observers have commented that it would be beneficial for the chairman of the board of a fund to be an independent director. We recognize that there may be benefits to an independent chairman of the board, such as the ability to control the boardroom agenda and manage the flow of information to the board, as well as the elimination of the idea that the management company is “negotiating with itself” during contract approval and renewals.

As discussed above, however, almost all funds have boards with at least a majority of independent directors. Thus, one could question whether there is a need to mandate that a fund’s chairman be independent because independent directors, representing a majority of a fund’s board, already are in a position to control the board and, if they deemed it appropriate, could already influence the agenda and the flow of information to the board. In addition, in response to the Investment Company Institute’s Report of the Advisory Group on Best Practices for Fund Directors, many fund boards have designated one or more “lead” independent directors.<sup>107</sup> As contemplated by the

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<sup>107</sup> See Enhancing a Culture of Independence and Effectiveness, Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute (June 24, 1999); *see also*, The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2: Corporate Governance (Jan. 9, 2003) (with respect to corporate boards,

Report, a lead independent director can coordinate the activities of the independent directors, act as a spokesperson for the independent directors in between meetings of the board, raise and discuss issues with counsel on behalf of the independent directors and chair separate meetings of the independent directors.

***7. Please describe the Commission’s expectations regarding the role of fund directors in the failure by numerous fund groups to provide “breakpoint” discounts to customers as promised in the funds’ prospectuses.***

Many mutual funds offer shares subject to front-end sales loads (“FESLs”). These sales loads are expressed as a percentage of the purchase price of the funds’ shares and are paid to broker-dealers that sell those shares. Funds frequently offer discounts on FESLs based on breakpoints which are linked to the dollar amounts of the purchases.<sup>108</sup> Funds that offer breakpoint discounts must disclose the breakpoints and related procedures in their offering documents.<sup>109</sup> Some funds disclose breakpoints in their prospectuses, while many others do so in the SAI.

Breakpoint discounts are available to investors on single purchases of shares. Funds also typically offer investors the option to take advantage of breakpoint discounts based on purchases made over time through a Letter of Intent (“LOI”) and/or a Right of Accumulation (“ROA”). An LOI is a written statement that an investor intends to purchase a stated dollar amount of fund shares within a certain period (frequently, 13

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recommending that a board’s chairman be independent or, if the chairman is not independent, that the board designate a lead independent director).

<sup>108</sup> For example, a fund may offer shares subject to a FESL equal to 5% for purchase amounts up to \$50,000, 4% for purchase amounts between \$50,000 and \$100,000, 3% for purchase amounts between \$100,000 and \$250,000, and so on until the FESL is reduced to 0% for purchase amounts over \$1 million. See *Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (March 2003) (“Staff Breakpoint Report”) <<http://www.sec.gov/news/studies/breakpointrep.htm>>.

<sup>109</sup> Form N-1A, Items 8(a)(1), 8(a)(2).

months). Under an LOI, the applicable breakpoint discount applies to the total amount of the investor's intended purchase on his or her first purchase and on subsequent purchases, so long as the breakpoint level is ultimately reached within the stated period. Under an ROA, an investor may aggregate shares owned in related accounts in some or all funds in the fund family to reach a breakpoint discount. This option also gives an investor the ability to take advantage of earlier purchases of shares of funds in his or her, and related, accounts. LOIs and ROAs may be combined for further benefits. Investors may elect to take advantage of one or more of these options, if offered, when buying a fund's shares.

Some funds sell their shares directly to investors. As a result, those funds have a direct relationship with their investors and have all of the information necessary to ensure that their transfer agents calculate and apply breakpoint discounts correctly. That information generally includes the name of the investor, the size of his or her purchase, whether the investor has any related accounts or other accounts, and the investment options selected, including the terms of any applicable LOIs and ROAs.

Other funds sell their shares through broker-dealers with which the funds' distributors have selling agreements. In recent years, many such broker-dealers have begun to use omnibus and other accounts that do not provide the funds' transfer agents with information about the individual investors and their transactions. In such cases, it is the broker-dealers, not the funds' transfer agents, that calculate and apply the breakpoint discounts. Consequently, these funds have little or no ability to verify that the selling broker-dealers are calculating and applying breakpoint discounts correctly.

The staffs of the SEC, NASD and the New York Stock Exchange ("NYSE") recently conducted examinations of 43 broker-dealers that sell funds that offer shares

subject to FESLs.<sup>110</sup> The purpose of the examinations was to determine whether investors were receiving the benefit of available breakpoint discounts on funds that offer shares subject to FESLs. The SEC, NASD and NYSE examiners reviewed thousands of fund transactions and found significant failures by the broker-dealers to deliver breakpoint discounts to eligible customers. Most instances in which customers did not receive breakpoint discounts for which they were eligible were caused by the broker-dealers' apparent failure to consider the customers' ownership of shares of funds in the same fund family or to link the customers' account with those of related persons under an ROA.<sup>111</sup> The Staff Breakpoint Report further found that investors more frequently received breakpoint discounts for which they were eligible when the fund's transfer agent, rather than a broker-dealer, calculated the FESLs.<sup>112</sup> However, many of the problems did not appear to be intentional failures to charge the correct sales loads.

The 1940 Act and the rules thereunder do not impose any specific obligation on fund boards with respect to the application of FESLs. Nevertheless, boards have a general fiduciary duty to act in the best interests of their funds, which generally requires boards to oversee operational matters in which problems have been identified. We believe that fund boards should oversee the administration of breakpoint discounts, particularly in light of the problems that have been identified in the recent examinations conducted by the staffs of the SEC, NASD and NYSE.

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<sup>110</sup> See Staff Breakpoint Report, *supra* note 108 at 10.

<sup>111</sup> See *id.* at 13.

<sup>112</sup> See *id.* at 2, 16.

In particular, we expect fund boards to review the adequacy of their funds' policies and procedures relating to FESLs. It would seem appropriate that fund boards obtain assurances, through the funds' principal underwriters, that broker-dealers selling their funds' shares have adequate policies and procedures to ensure that fund investors receive the breakpoint discounts to which they are entitled.

As part of the Commission's review of the breakpoint issue, the NASD convened a task force comprised of regulators and representatives from broker-dealers, funds, fund administrators and operational personnel to review solutions to help ensure that mutual fund investors receive the breakpoint discounts to which they are entitled.<sup>113</sup> The task force has met several times and it is expected that it will formulate recommendations, both for regulatory action and voluntary industry measures, that can minimize problems in this area.<sup>114</sup>

***8. Please discuss the frequency of rejection of management contracts by fund directors in the past ten years.***

To the best of our knowledge, fund directors have infrequently terminated or rejected management or investment advisory contracts during the past ten years. The Commission does not maintain data on the frequency of the rejection or termination of, or other changes to, investment advisory contracts by fund directors.<sup>115</sup> Funds and their

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<sup>113</sup> See Letter from Harvey L. Pitt to Robert R. Glauber, Chairman and Chief Executive Officer, NASD, Matthew P. Fink, President, Investment Company Institute and Marc E. Lackritz, President, Securities Industry Association (Jan. 125, 2003). See also, NASD News Release dated February 18, 2003.

<sup>114</sup> One issue we recommend the Commission consider is requiring that funds disclose breakpoint information in their prospectus, rather than their SAI.

<sup>115</sup> Before funds enter into investment advisory contracts with new investment advisers, or amend existing investment advisory contracts, the funds' boards of directors and shareholders must approve the new or amended contracts. To obtain shareholder approval, a fund typically distributes a proxy statement to its shareholders that discloses the circumstances surrounding the fund's decision to enter into a new contract or to amend the existing contract. The Commission's

directors are not required to seek Commission approval or provide the Commission with notice of the directors' rejection or termination of investment advisory contracts between the funds and their investment advisers.

Fund investment advisory contracts are required by law to provide that fund directors, with 60 days' notice, may terminate the contracts at any time, without the payment of any penalty.<sup>116</sup> In addition, a fund's investment advisory contract generally must be re-approved each year by a majority of the independent directors of the fund.<sup>117</sup> A fund's independent directors may effectively terminate or reject the fund's investment advisory contract by not voting to approve its continuance.<sup>118</sup> We understand that fund directors have terminated investment advisory contracts between their funds and the funds' investment advisers for various reasons, including disputes between directors and investment advisers over the quality of information provided to the directors by the investment adviser regarding the adviser's management of the fund, the fund's investment techniques, converting the fund from a closed-end fund to an open-end fund, and merging the fund with another fund.

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staff generally reviews the proxy statements for compliance with the rules regulating the solicitation of proxies, but does not maintain data regarding the frequency of terminations of investment advisory contracts by fund directors or data regarding the frequency of other changes to advisory contracts, such as increases or decreases in advisory fees.

<sup>116</sup> Section 15(a) of the 1940 Act requires all fund investment advisory contracts to contain that provision.

<sup>117</sup> Section 15(a) of the 1940 Act generally makes it unlawful for any person to serve as an investment adviser to a fund except pursuant to a written contract that has been approved by a majority of the fund's outstanding voting securities and a majority of the fund's independent directors. Typically, the fund's investment adviser, as the initial, sole shareholder of the fund, initially approves the investment advisory contract. After the initial two-year contractual period, section 15 requires that the contract be renewed annually by a majority of the fund's independent directors or its shareholders.

<sup>118</sup> Fund directors also may decline to approve proposed amendments to existing investment advisory contracts, and may decline to approve proposed investment advisory contracts for newly created funds.

***9A. Please discuss the legal standard that applies to the fiduciary obligations of fund directors and advisers with respect to approval of management contracts, and issues relating to the utility of that standard in light of your response to question number 8.***

**A. Legal Standards.**

Fund directors and investment advisers have a number of obligations with respect to the approval of management contracts. Those obligations stem from principles of fiduciary duty under state and federal law and the specific requirements of the 1940 Act.

In particular, fund directors are subject to fiduciary duties of care and loyalty. The duty of care generally requires that directors act with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position.<sup>119</sup> The duty of loyalty generally requires fund directors to exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization (*e.g.*, the investment adviser).<sup>120</sup> Under state law, assuming a decision is otherwise consistent with a director's fiduciary duties, the business judgment rule can protect fund directors from liability for their decisions, including their approval of a fund's investment advisory contract. The business judgment rule applies as long as the directors acted in good faith, were reasonably informed, and rationally believed that the action taken was in the best interests of the fund.<sup>121</sup>

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<sup>119</sup> See, *e.g.*, *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) and *Norlin Corp v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984).

<sup>120</sup> See the policy directives contained in sections 1(b)(2), (4) and (6) of the 1940 Act. See also, *Norlin Corp v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984), citing *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

<sup>121</sup> See, *e.g.*, *Salomon v. Armstrong*, 1999 Del. Ch. LEXIS 62, 23 (Del. Ch. Mar. 25, 1999). See generally Dennis J. Block *et al.*, *THE BUSINESS JUDGMENT RULE - FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 1998).

The 1940 Act also imposes specific statutory obligations on fund directors’ approval and renewal of fund investment advisory contracts. Those obligations enhance the integrity of the approval and renewal process by, among other things, enhancing the authority of funds’ independent directors.<sup>122</sup> For instance, the 1940 Act requires that a majority of a fund’s independent directors must approve the fund’s investment advisory contract at an in-person meeting called for that purpose,<sup>123</sup> before the investment adviser may serve or act as the fund’s investment adviser.<sup>124</sup> The 1940 Act also generally requires that a fund’s independent directors must annually approve the fund’s investment advisory contract at an in-person meeting called for that purpose.<sup>125</sup> Furthermore, in connection with the initial approval and any renewal of a fund’s investment advisory contract, the 1940 Act specifically requires fund directors to request and evaluate, and the investment adviser to furnish, “such information as may reasonably be necessary to evaluate” the terms of the contract.<sup>126</sup>

The 1940 Act further requires fund directors to evaluate the amount of compensation that the fund pays to its investment adviser under the fund’s investment

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<sup>122</sup> The 1940 Act requires that at least 40% of a fund’s directors must be independent. *See* section 10(a) of the 1940 Act. In 2001, the Commission strengthened the role of independent directors by requiring that a majority of a fund’s directors be independent if the fund relies on certain rules that exempt funds from various requirements of the 1940 Act. *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). Independent directors comprise a majority of most fund boards.

<sup>123</sup> The “in-person meeting requirement” was intended “to assure informed voting on matters which require action of the board of directors of registered investment companies.” Sen. Rep. No. 91-184, 91st<sup>th</sup> Cong., 1st Sess. 4082 (1969).

<sup>124</sup> *See* Section 15(c) of the 1940 Act, which requires approval of fund investment advisory contracts by the vote of a majority of the directors who are not parties to such contract or agreement, or interested persons of any such a party, cast in person at a meeting called for the purpose of voting on such approval.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

advisory contract. Section 36(b) imposes on fund investment advisers a fiduciary duty with respect to their receipt of compensation from funds.<sup>127</sup> Congress adopted section 36(b) in response to concerns that fund advisory fees were not subject to the usual competitive pressures because funds typically are organized and operated by their investment advisers.<sup>128</sup> Director’s responsibilities under section 36(b) involve the evaluation of whether the compensation that is paid to a fund’s investment adviser is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.”<sup>129</sup> When approving and renewing investment advisory agreements, particularly the compensation to be paid to the investment advisers, fund directors typically consider the following relevant factors:

- The nature and quality of all of the services provided by the adviser (either directly or through affiliates), including the performance of the fund;
- The adviser’s cost in providing the services and the profitability of the fund to the adviser;
- The extent to which the adviser realizes economies of scale as the fund grows larger;
- The “fall-out” benefits that accrue to the adviser and its affiliates as a result of the adviser’s relationship with the fund (*e.g.*, soft dollar benefits);
- The performance and expenses of comparable funds; and

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<sup>127</sup> Section 36(b) specifically authorizes the Commission, and any fund shareholder, to bring an action in federal district court against the fund’s investment adviser for a breach of fiduciary duty “with respect to the receipt of compensation for services, or of payments of a material nature” made by the fund to the investment adviser (or to an affiliated person of the investment adviser).

<sup>128</sup> See SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89<sup>th</sup> Cong., 2d Sess. 10-12, 126-27, 130-32 (1966). See also, DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 317-319 (May 1992) (“Protecting Investors”).

<sup>129</sup> *Gartenberg v. Merrill Lynch Asset Management, Inc.* 694 F.2d 923, 928 (2d Cir. 1982) (“*Gartenberg I*”). See also, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 740 F.2d 190 (2d Cir. 1984).

- The volume of transaction orders that must be processed by the adviser.

Fund directors should not approve or renew an investment advisory contract if the investment adviser's receipt of compensation under the contract would constitute a breach of the adviser's fiduciary duty under section 36(b).

Like fund directors, fund investment advisers are subject to fiduciary duties under state and federal law in connection with the approval and renewal of investment advisory contracts.<sup>130</sup> Fund investment advisers are subject to duties of care and loyalty<sup>131</sup> and must affirmatively disclose to a fund's board of directors all facts that are material to the board's approval and renewal of the investment advisory contract.<sup>132</sup> In particular, a fund's investment adviser is required by the 1940 Act to furnish "such information as may reasonably be necessary" for the fund's directors to evaluate the fund's investment advisory contract.<sup>133</sup> Furthermore, the 1940 Act authorizes the Commission to sue any fund investment adviser for "any act or practice constituting a breach of fiduciary duty involving personal misconduct" in connection with, among other things, the approval or renewal of the fund's investment advisory contract.<sup>134</sup>

## **B. Utility of the Standards in Light of Infrequent Terminations of Fund Advisory Contracts**

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<sup>130</sup> See, e.g., *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979).

<sup>131</sup> See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963); *In the Matter of Kemper Financial Services, Inc. et al.*, Investment Advisers Act Release No. 1476 (Mar. 2, 1995); *In the Matter of Joan Conan*, Investment Advisers Act Release No. 1446 (Sept. 30, 1994).

<sup>132</sup> *Id.*

<sup>133</sup> See Section 15(c) of the 1940 Act.

<sup>134</sup> See Section 36(a) of the 1940 Act.

The infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that the legal standards that are applicable to the approval of investment advisory contracts are inadequate, or that independent directors have not been forceful enough in representing shareholders' interests. Fund directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds. For example, fund directors may reasonably conclude that it would be in the best interests of the fund and its shareholders to renegotiate, rather than to terminate, the fund's investment advisory contract. Fund directors also may reasonably conclude that it would be in the best interests of the fund and its shareholders to require the fund's investment adviser to take appropriate steps to improve its performance, such as by hiring a new portfolio manager for the fund, move to a team approach of portfolio management, increase the adviser's investment research capacity, insist on retention of a sub-adviser, merge or liquidate the fund, close a fund to new investors, or adjust the fee structure, such as including a performance fee component to the advisory fee, without seeking to terminate the investment advisory contract. In sum, fund directors are empowered with the ability to terminate a fund's investment advisory contract when the directors determine that it would be in the best interests of the fund and its shareholders to do so, and they are empowered to renegotiate the contract and/or take other remedial steps when that would be the better course.

When fund directors consider whether or not to approve an investment advisory contract with an investment adviser, the directors generally must act in the best interests of the fund and its shareholders in light of all of the relevant facts and circumstances. The directors must carefully consider all information that is material to their evaluation of

the terms of the contract, including the amount of the compensation to be paid by the fund to the investment adviser. If the fund's directors are not satisfied with the performance of the investment adviser under the contract, however, termination of the contract is not the only course of action that is available to the directors, and termination may not necessarily be in the best interests of the fund.

Under certain circumstances, however, the termination of a fund's investment advisory contract may be in the best interests of the fund and its shareholders. For instance, fund directors may decide to terminate the fund's investment advisory contract because the fund's investment adviser lacks the financial resources to adequately perform its obligations under the contract. In deciding whether termination of the contract would be in the best interests of the fund, the directors would need to consider, among other things, whether the benefits of termination would outweigh the potential costs and disruption associated with the termination. Failure to terminate could constitute a breach of fiduciary duty by the fund's directors. Traditionally, the Commission and the courts have avoided substituting their business judgment regarding the approval of fund investment advisory contracts for the judgment of the fund boards.<sup>135</sup>

***9.B. Please discuss the effectiveness of the Commission's new rules requiring disclosure in the Statement of Additional Information of the board's rationale for approving management contracts, including an analysis of possible alternative disclosure venues for providing this information to investors.***

The responsibility for evaluating and approving a fund's advisory contract is one of the most important governance obligations assigned to boards of directors under the

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<sup>135</sup> See, e.g., *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F.Supp. 962, 971 (S.D. N.Y. 1987) *aff'd*, 835 F.2d 45 (2d Cir. 1987). "The legislative history of the [Investment Company] Act clearly indicates that it is not the role of the Court to 'substitute its business judgment for that of the mutual fund's board of directors in the area of management fees.'" *Id.* (quoting S. Rep. No. 194, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Ad. News 4902).

1940 Act. Recognizing this, the Commission recently adopted amendments to its rules and forms requiring a discussion in a fund's SAI relating to the fund board's basis for approving the renewal of an existing investment advisory contract. Funds must provide appropriate detail in this discussion regarding the board's basis for approving the contract, including the particular factors forming the basis of the board's determination. The Commission made clear that boilerplate disclosure, or the mere recitation of conclusory statements or lists of factors considered by the board, would not be sufficient.

Funds generally have been required to provide this discussion since the beginning of 2002. Much of the disclosure that the staff has reviewed has been satisfactory; however, as you might expect, we have seen some disclosure that is excellent and some that is poor.<sup>136</sup> The poorer disclosure recited nothing but boilerplate or conclusory statements of the very sort warned against by the Commission; it also failed to relate the board's consideration to the specific circumstances of the fund, the adviser, and the contract. In such instances, the staff insisted on improved disclosure.

The better disclosure that we have seen addressed specific factors that were most significant in the board's consideration, and factors that were not considered or deemed less significant. Among other things, the better disclosure also: (i) addressed the quality of specific services provided to the fund; (ii) addressed the particular experience and performance of the adviser with the particular fund and/or the investment objectives and strategies used by the fund; and (iii) provided a non-cursory comparison of the fund's advisory fees to those of other similarly situated, albeit unnamed, funds.

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<sup>136</sup> The staff does not review all disclosure filings made by mutual funds.

In adopting the changes to require this disclosure, the Commission determined that funds should provide the information to investors in the SAI, and not in the prospectus. In this regard, we note that even before the Commission acted, fund shareholders were provided with this information in all fund proxy statements seeking a vote on an advisory agreement.

The Commission often faces the decision of what information should be provided to investors in the prospectus or the SAI (or in shareholder reports). Notably, the Commission in 1998 decided against including in the prospectus certain other information about funds' boards during its top-to-bottom overhaul of the mutual fund prospectus. It is significant that, here, the required discussion relates to how fund directors fulfill a legal obligation required of all fund boards. The staff considered this when it made its recommendation to the Commission to include the information in the SAI. Further, the staff's experience to date has been that a good discussion might have to be relatively lengthy; such disclosure, while obviously important, arguably would obscure the import of other information in the prospectus.

Alternatively, the Commission could have required this information in the annual report to shareholders. The vast majority of commenters on the Commission's proposal to provide the information in the SAI opposed it; many argued that the board's rationale for approving the contract already was sufficiently and appropriately disclosed in the proxy statement. But as the Commission noted in its proposing release, in recent years the proxy statement has become an ineffective vehicle for communicating information to fund shareholders on a regular basis because most funds generally are no longer required

by state law to hold annual meetings.<sup>137</sup> This also helps explain why the Commission required this disclosure in the annually updated SAI: since it did not appear from the comments that all shareholders would be interested in this information, and as it would be made available to interested shareholders in the SAI and provided to shareholders in pertinent proxy statements, putting this information in the annual report seemed unnecessary.

***10. Section 301 of the Sarbanes-Oxley Act directs the Commission to require the stock exchanges to prohibit the listing of any security of a public company that does not have an audit committee meeting certain criteria. Because only closed-end funds and certain exchange-traded open-end funds are listed on stock exchanges, this provision does not apply to most open-end investment companies. Please discuss whether mutual fund investors would benefit from similar corporate governance reforms.***

Section 301 of the Sarbanes-Oxley Act requires the Commission, by rule, to direct the national securities exchanges and national securities associations (“SROs”) to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees.<sup>138</sup> The Commission adopted new rule 10A-3 under the 1934 Act to implement section 301 of the Sarbanes-Oxley Act on April 9, 2003.<sup>139</sup> Under section 301 and rule 10A-3, SROs are prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any

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<sup>137</sup> This is not the case for closed-end funds listed on an exchange. The exchanges generally require an annual meeting as part of their listing requirements, and closed-end fund shareholders therefore generally receive proxy statements with this disclosure.

<sup>138</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>139</sup> Investment Company Act Release No. 26001 (Apr. 9, 2003).

registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;

- Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

Because section 301 requires the Commission to direct the SROs to prohibit the listing of any security of an issuer that is not in compliance with these audit committee standards, new rule 10A-3 applies only to listed issuers, including listed investment companies. Thus, the new rule would generally cover closed-end investment companies, but would not cover most mutual funds.

While many mutual funds already employ some or all of the principles embodied in rule 10A-3, extending the audit committee requirements of the rule to mutual funds, as well as closed-end funds, could further benefit mutual fund investors. While mutual fund financial statements may, in many cases, be simpler than those of some operating companies, the underlying financial systems, reporting mechanisms, and internal controls are sufficiently complex that a mutual fund could benefit from each of the corporate governance reforms embodied in section 301 of the Sarbanes-Oxley Act and the Commission's implementing rules. However, assessing the benefits should be balanced with the costs to funds and their shareholders.

First, fund governance would be enhanced if each member of the audit committee of a mutual fund were required to be independent. As the Commission noted in the release adopting rule 10A-3, an audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.<sup>140</sup>

Second, a requirement that the audit committee appoint, compensate, retain, and oversee the outside auditor could help to further the objectivity of financial reporting. The auditing process may be compromised when a fund's outside auditors view their main responsibility as serving the fund's management rather than its board or audit committee. We note that the issue of appointment of the fund's independent auditor has already been addressed for both listed and non-listed funds by section 202 of the Sarbanes-Oxley Act and the Commission's auditor independence rules. Section 202 and the Commission's rules require that the audit committee of a fund pre-approve all audit, review, or attest engagements required under the securities laws.<sup>141</sup>

Third, requiring the establishment of formal procedures by a fund's audit committee for receiving and handling complaints could serve to facilitate disclosure of questionable practices, encourage proper individual conduct, and alert the audit committee to potential problems before they have serious consequences.

Fourth, a requirement that a fund's audit committee have the authority to engage outside advisors, including counsel, as it determines necessary could assist the audit

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<sup>140</sup> In 2001, the Commission adopted rule 32a-4 to encourage mutual funds to have independent audit committees. Rule 32a-4 exempts a fund from the requirement that selection of the fund's accountant be submitted to shareholders for ratification at the next annual meeting, if the fund has an audit committee composed solely of independent directors.

<sup>141</sup> See Investment Company Act Release No. 25915 (Jan. 28, 2003); rule 2-01(c)(7) of Regulation S-X. The audit committee is also required to pre-approve all permissible non-audit services.

committee in performing its role effectively. The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye.

Fifth, a requirement for the fund to provide for appropriate funding to compensate the independent auditor and the advisors employed by the audit committee should further the required standard relating to the audit committee's responsibility to appoint, compensate, retain, and oversee the outside auditor, and add meaning to the standard relating to the audit committee's authority to engage independent advisors.

The staff has not identified any aspect of the Sarbanes-Oxley Act's corporate governance standards from which mutual funds should be exempted. The provisions of the Sarbanes-Oxley Act generally do not distinguish between investment companies and operating companies.<sup>142</sup> As a result, outside of section 301, which, by its terms, applies only to listed issuers, the Commission's rules generally apply the corporate governance requirements of the Sarbanes-Oxley Act to mutual funds. These requirements include section 202, which requires that audit committees pre-approve audit and permitted non-audit services,<sup>143</sup> and section 407, which requires an issuer to disclose whether at least one member of its audit committee is a "financial expert."<sup>144</sup> These requirements, which should help to improve the quality of the financial disclosure that an issuer provides to its

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<sup>142</sup> Section 405 of the Sarbanes-Oxley Act exempts registered investment companies from sections 401 (disclosure of material off-balance sheet transactions and pro forma financial information), 402 (prohibition on personal loans to executives), and 404 (management assessment of internal controls).

<sup>143</sup> See section 10A(i) of the 1934 Act; Investment Company Act Release No. 25915 (Jan. 28, 2003).

<sup>144</sup> See Investment Company Act Release No. 25914 (Jan. 27, 2003) (implementing section 407 of the Sarbanes-Oxley Act with respect to funds).

investors, are as important for investors in mutual funds as they are for investors in operating companies.

***11. Please describe the obligations of fund directors regarding approval of distribution arrangements under rule 12b-1 and otherwise. Please discuss whether the rule should be updated in light of the evolution of fund distribution since the rule's adoption.***

Fund directors have a number of obligations regarding the use of fund assets to pay for the distribution of the fund's shares. Those obligations stem from the requirements of rule 12b-1 under the 1940 Act, and principles of fiduciary duty applicable to fund directors under state and federal law.

Rule 12b-1 prohibits any mutual fund from acting as a distributor of its shares, either directly or indirectly, unless the fund complies with the requirements of the rule.<sup>145</sup> Rule 12b-1 generally provides that a fund is acting as a distributor of its shares if it engages "directly or indirectly" in "financing any activity which is primarily intended to result in the sale of shares," such as the "compensation of underwriters, dealers and sales personnel."

Under the rule, a fund's directors generally are obligated to approve initially, and oversee on an ongoing basis, the use of fund assets to pay for the distribution of fund shares. The payment of any distribution expense by a fund must be made pursuant to a written plan that describes all material aspects of the proposed financing of distribution (a

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<sup>145</sup> Section 12(b) of the 1940 Act prohibits an open-end investment company from acting:

as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

In 1980, the Commission adopted rule 12b-1 under the provisions of this section. Investment Company Act Release No. 11414 (Oct. 28, 1980).

“12b-1 plan”). The directors of a fund who vote to approve the implementation or continuance of a 12b-1 plan must conclude, in the exercise of their reasonable business judgment and in light of their fiduciary duties under state law<sup>146</sup> and under sections 36(a) and (b) of the 1940 Act,<sup>147</sup> that there is a reasonable likelihood that the plan will benefit the fund and its shareholders.<sup>148</sup> Under the rule, directors have the duty to request and evaluate such information as may reasonably be necessary to make an informed determination of whether a 12b-1 plan should be implemented or continued, and directors should consider and give weight to all pertinent factors.<sup>149</sup>

More specifically, the requirements of rule 12b-1 that relate to fund directors are as follows:

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<sup>146</sup> As noted above, Fund directors are subject to state law fiduciary duties of care and loyalty. The duty of care generally requires that directors act in good faith and with that degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position. *See Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984). *See generally* James Solheim and Kenneth Elkins, 3A Fletcher Cyclopedic of the Law of Private Corporations § 1029 (perm. ed.). The duty of loyalty generally requires that directors exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization. *See Norlin Corp.*, 744 F.2d at 264 (*citing Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)). *See generally* Beth A. Buday and Gail A. O'Grady, 3 Fletcher Cyclopedic of the Law of Private Corporations § 913 (perm. ed.).

<sup>147</sup> Section 36(a) of the 1940 Act authorizes the Commission to institute civil actions in federal district court against fund directors who engage in conduct constituting a breach of fiduciary duty involving personal misconduct. The legislative history of the section indicates that: "In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct." H.R. Rep. No. 1382, 91<sup>st</sup> Cong., 2d Sess. 37 (1970); S. Rep. No. 184, 91<sup>st</sup> Cong., 2d Sess. 36 (1969). Section 36(b) of the 1940 Act authorizes the Commission and fund shareholders to institute civil actions in federal district court against fund directors for breach of fiduciary duty with respect to payments made by the fund to the fund's investment adviser and affiliated persons of the adviser.

<sup>148</sup> Rule 12b-1(e).

<sup>149</sup> Rule 12b-1(d).

- The 12b-1 plan must be approved by a vote of the board of directors of a fund, and by the directors of the fund who are independent, cast in person at a meeting called for the purpose of voting on the plan;<sup>150</sup>
- The 12b-1 plan must provide that any person authorized to direct the disposition of monies paid or payable by the fund pursuant to the 12b-1 plan or any related agreement shall provide to the fund’s board of directors, and the directors shall review, at least quarterly, a written report of the amounts so expended and the purposes for which the expenditures were made;<sup>151</sup>
- The 12b-1 plan must provide that all material amendments to the plan must be approved by a vote of the fund’s directors, and by the fund’s independent directors, cast in person at a meeting called for the purpose of voting on the amendments;<sup>152</sup>
- The 12b-1 plan’s continuance must be approved at least annually by the fund’s board as well as its independent directors;<sup>153</sup> and
- A majority of the fund’s directors must be independent, the independent directors must select and nominate any other independent directors, and any person who acts as legal counsel for the independent directors of the fund must be an “independent counsel” as defined in rule 0-1 under the 1940 Act.<sup>154</sup>

These requirements are intended, in part, to address the potential conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses. When a fund bears its own distribution expenses, the fund’s investment adviser is spared the cost of bearing those expenses itself, and the adviser

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<sup>150</sup> Rule 12b-1(b)(2). An independent, or disinterested, director is a director that is not an “interested person” of the fund as defined in section 2(a)(19) of the 1940 Act. In addition, for the purposes of rule 12b-1, an independent director must also have no direct or indirect financial interest in the 12b-1 plan or any agreements under that plan. *Id.*

<sup>151</sup> Rule 12b-1(b)(3)(ii).

<sup>152</sup> *Id.*

<sup>153</sup> Rule 12b-1(b)(3)(i).

<sup>154</sup> Rule 12b-1(c)(1) and (2).

benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.<sup>155</sup>

When the Commission adopted rule 12b-1 in 1980, it enumerated the following factors that it believed, at the time, would normally be relevant to a determination by a fund's board of directors of whether to use fund assets to pay for distribution:

- (1) The need for independent counsel or experts to assist the directors in reaching a determination;
- (2) The nature of the problems or circumstances which purportedly make implementation or continuation of a 12b-1 plan necessary or appropriate;
- (3) The causes of such problems or circumstances;
- (4) The way in which the plan would address these problems or circumstances and how it would be expected to resolve or alleviate them, including the nature and approximate amount of the expenditures, the relationship of such expenditures to the overall cost structure of the fund, the nature of the anticipated benefits, and the time it would take for those benefits to be achieved;
- (5) The merits of possible alternative plans;
- (6) The interrelationship between the plan and the activities of any other person who finances or has financed distribution of the fund's shares, including whether any payments by the fund to such other person are made in such a manner as to constitute the indirect financing of distribution by the fund;
- (7) The possible benefits of the plan to any other person relative to those expected to inure to the fund;
- (8) The effect of the plan on existing shareholders; and
- (9) In the case of a decision on whether to continue a plan, whether the plan has in fact produced the anticipated benefits for the fund and its shareholders.<sup>156</sup>

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<sup>155</sup> See generally Investment Company Act Release No. 10252 (May 23, 1978).

<sup>156</sup> See Investment Company Act Release No. 11414 (Oct. 28, 1980).

Fund directors also have statutory obligations regarding distribution arrangements that are not within the scope of rule 12b-1. Funds typically employ principal underwriters. Under section 15(c) of the 1940 Act, a majority of a fund's independent directors must vote to approve any contract, or any renewal thereof, under which a person agrees to act as the fund's principal underwriter. In addition, under section 15(b) of the 1940 Act, a principal underwriting contract may continue in effect for more than two years from the date of its execution only if the fund's board of directors or shareholders approve its continuance annually. In approving principal underwriting contracts, fund directors are subject to their fiduciary duties under section 36 of the 1940 Act and state law, as discussed above.

In December 2000, the Commission's staff recommended to the Commission that the Commission should consider reviewing and amending the requirements of rule 12b-1.<sup>157</sup> The staff's recommendation that the Commission should consider reviewing and amending the requirements of rule 12b-1 was based in part on the changes in the manner in which funds have been marketed and distributed, and the experience gained from observing how the rule has operated, since it was adopted in 1980.<sup>158</sup>

Rule 12b-1 essentially requires fund directors to view a fund's 12b-1 plan as a temporary measure even in situations where the fund's existing distribution arrangements would collapse if the 12b-1 plan were terminated. As described previously, under the rule, fund directors must adopt a 12b-1 plan for not more than one year, may terminate the plan even before the end of that year, and must consider at least annually whether the

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<sup>157</sup> See Staff Fee Study, *supra* note 1.

<sup>158</sup> See Staff Fee Study, *supra* note 1.

plan should be continued. In addition, many directors believe that when they consider whether to approve or continue a 12b-1 plan, they are required to evaluate the plan as if it were a temporary arrangement. As discussed above, the adopting release for rule 12b-1 included a list of factors that fund boards might take into account when they consider whether to approve or continue a 12b-1 plan. Many of the factors presupposed that funds would typically adopt 12b-1 plans for relatively short periods in order to solve a particular distribution problem or to respond to specific circumstances, such as net redemptions. Although the factors are suggested and not required, some industry participants indicate that the factors are given great weight by fund boards. Some argue that the recitation of the factors impedes board oversight of 12b-1 plans because the temptation to rely on the factors, whether they are relevant to a particular situation or not, is too great to ignore. Although the factors may have appropriately reflected industry conditions as they existed in the late 1970s, others argue that many have subsequently become obsolete because, today, many funds adopt a 12b-1 plan as a substitute for or supplement to sales charges or as an ongoing method of paying for marketing and distribution arrangements.

The mutual fund industry utilizes a number of marketing and distribution practices that did not exist when rule 12b-1 was adopted. For example, many funds offer their shares in multiple classes – an organizational structure that permits investors to choose whether to pay for fund distribution and marketing costs up-front (via front-end sales charge), over time from their fund investment (via 12b-1 fee), when they redeem (via deferred sales charge), or in some combination of the above. Rule 12b-1 plans are integral to these arrangements – they are the means by which the brokers that sell fund

shares under these arrangements are paid. Some industry observers argue that fund principal underwriters and boards of directors may have good reason to view this type of 12b-1 plan as an indefinite commitment because a multi-class distribution arrangement could not continue to exist if the associated 12b-1 plan were terminated or not renewed.

Other funds offer their shares primarily through fund supermarkets -- programs sponsored by financial institutions through which their customers may purchase and redeem a variety of funds, with or without paying transaction fees. Fund supermarkets are popular because they have been heavily advertised, indicate or imply that the sponsor has screened the participating funds for quality of management, enable investors to consolidate their holdings of funds from different fund groups in a single brokerage account and to receive a consolidated statement listing all fund holdings. Many funds that offer shares through fund supermarkets adopt 12b-1 plans to finance the payment of fees that are charged by the sponsors of fund supermarkets. Some may argue that because these 12b-1 plans are essential to the funds' participation in fund supermarket programs, these 12b-1 plans may be legitimately viewed as indefinite commitments. In addition, because most funds pay fees to fund supermarkets for a mixture of distribution and non-distribution services, it can be difficult to determine when and how rule 12b-1 applies to these fees. Although the Division of Investment Management has provided additional guidance about what constitutes a distribution expense,<sup>159</sup> questions still remain about

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<sup>159</sup> Letter from Douglas Scheidt, Associate Director of the Commission's Division of Investment Management to Craig S. Tyle, General Counsel of the Investment Company Institute (pub. avail. Oct. 30, 1998).

how to determine whether a particular activity is primarily intended to result in the sale of fund shares, and therefore must be covered by a 12b-1 plan.<sup>160</sup>

A third significant change in distribution practices is that some fund distributors are now able to finance their efforts by borrowing from banks, finance companies, or the capital markets because they can use anticipated 12b-1 revenues as collateral, or as the promised source of payment. If a fund adopts a 12b-1 plan, the right of its distributor to receive future 12b-1 fees from the fund is an asset of the distributor. Some distributors borrow from banks, finance companies, or other financial intermediaries, using this asset as collateral. Other distributors issue debt securities (asset-backed securities) for which the payment of principal and interest is backed by the distributors' contractual right to receive a stream of future 12b-1 fees. Although the independent directors of a fund have the legal right to terminate a fund's 12b-1 plan, the independent directors may be less likely to do so if the fund's future 12b-1 fees have been pledged to secure a bank loan or to pay principal and interest due on asset-backed securities.

Another development that we have observed is the increasing use by some funds of a portion of the brokerage commissions that they pay on their portfolio transactions to compensate broker-dealers for distribution of fund shares. Certain of these arrangements, we believe, result in the use of fund assets to facilitate distribution and should be reflected in rule 12b-1 distribution plans. For instance, some fund investment advisers direct broker-dealers that execute transactions in the fund's portfolio securities to pay a portion of the fund's brokerage commissions to selling broker-dealers. In some

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<sup>160</sup> Nonetheless, bundled fees that purport to include services such as transfer agency and shareholder servicing fees can be scrutinized by directors to allocate the proportion of the fee that is for distribution and thus is includable in a 12b-1 plan.

instances, the selling broker-dealers perform no execution-related services in connection with the portfolio transactions. These payments are intended to compensate selling broker-dealers for selling fund shares and are a use of fund assets for distribution of fund shares. We intend to recommend that the Commission take action to clarify the circumstances pursuant to which the use of brokerage commissions to facilitate the distribution of fund shares should be reflected in a rule 12b-1 plan.

In view of the foregoing, we will continue to assess the issues raised by rule 12b-1 and discuss with the Commission the current status of the rule in light of our recommendation in December 2000 and the changes in fund distribution practices that have developed since the rule was adopted over twenty years ago.

***12. I understand that investment advisers to funds make so-called “revenue-sharing” payments to facilitate distribution of fund shares. One commentator has estimated that, in 2000, fund sponsors paid brokers as much as \$2 billion to obtain distribution benefits – roughly four times the amount funds paid for advertising. This commentator described revenue-sharing as “the dirty little secret of the mutual fund industry ... Nobody likes to talk about it, but the reality is that it has become a major expense.” Please describe how these arrangements work, the impact of these expenses on investors, the legal issues raised by such arrangements with respect to Rule 12b-1, directors’ obligations with respect to these arrangements, and the transparency of these arrangements and their associated costs.***

#### **A. Revenue-Sharing Payments and Rule 12b-1**

A “revenue-sharing” payment generally refers to any payment that is made by a fund’s investment adviser, from its own resources, to finance the distribution of the fund’s shares. As explained below, revenue-sharing payments generally are not a fund expense. Fund investment advisers use revenue-sharing payments primarily to compensate broker-dealers that sell the funds’ shares (“selling broker-dealers”).<sup>161</sup>

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<sup>161</sup> Based on information derived from recent examinations conducted by Commission staff of funds, their investment advisers and broker-dealers, we understand that fund investment advisers

As a general matter, funds intensely compete to secure a prominent position in the distribution systems that selling broker-dealers maintain for distributing fund shares. Over the past decade, selling broker-dealers have increasingly demanded compensation for distributing fund shares that is in addition to the amounts that they receive from sales loads and rule 12b-1 fees. To meet this demand, fund investment advisers have increasingly made revenue-sharing payments to the selling broker-dealers, which may be a “major expense” for some investment advisers. Further, the allocation of fund brokerage to “supplement” the advisers payments to broker-dealers for distribution generally is bundled into the commission rate and not separately identifiable or reported as 12b-1 fees. Under certain circumstances, the portion of the commission payment devoted to payment for distribution is more discernable. See the answer to Question 11 regarding use of brokerage commissions to facilitate distribution.

The primary legal issue raised by a fund investment adviser’s revenue-sharing payments is whether the payments are an indirect use of the fund’s assets to finance the distribution of its shares and therefore must be made in accordance with the requirements of rule 12b-1 under the 1940 Act. A mutual fund that directly or indirectly finances any activity that is primarily intended to result in the sale of fund shares must comply with rule 12b-1.<sup>162</sup> Whether a fund indirectly finances the distribution of its shares through

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typically make revenue-sharing payments to selling broker-dealers at the rate of between .20% and .25% of the annual gross sales of fund shares made by a broker-dealer, and between .01% and .05% of the net asset value of fund shares held by customers of a broker-dealer.

<sup>162</sup> As discussed above, section 12(b) and rule 12b-1 thereunder address the conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses. In particular, when a fund bears its own distribution expenses, the fund’s investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund’s distribution expenditures result in an increase in the fund’s assets and a concomitant increase in the advisory fees received by the adviser. The requirements of rule 12b-1 address those concerns.

revenue-sharing payments that are made by its investment adviser depends on all of the facts and circumstances.

In the Commission's view, a fund indirectly finances the distribution of its shares within the meaning of rule 12b-1 if any allowance is made in the fund's investment advisory fee to provide money to finance the distribution of the fund's shares. In that case, the investment advisory fee essentially serves as a conduit for the indirect use of the fund's assets for distribution, and the portion of the advisory fee that is used to finance the distribution of the fund's shares must be paid in compliance with the requirements of rule 12b-1.<sup>163</sup>

On the other hand, revenue-sharing payments do not involve an indirect use of a fund's assets for distribution if the fund's investment adviser makes the payments from the profits of its investment advisory fee that are "legitimate" or "not excessive," *i.e.*, if they are derived from an investment advisory contract that does not result in a breach of the investment adviser's fiduciary duty under section 36(b) of the 1940 Act.<sup>164</sup> Whether the profits are legitimate depends on whether the compensation received by the investment adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."<sup>165</sup> Factors relevant to this determination are, among other things, the nature and quality of all of the services provided by the adviser (either directly or through

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<sup>163</sup> See *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414 (Oct. 28, 1980).

<sup>164</sup> As previously noted, Section 36(b) of the 1940 Act imposes on fund investment advisers a fiduciary duty with respect to their receipt of compensation from the fund.

<sup>165</sup> See *Gartenberg I*, *supra* note 129 at 928.. See also *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 740 F. 2d 190, 192 (2d Cir. 1984).

affiliates), including the performance of the fund, the adviser's cost in providing the services and the profitability of the fund to the adviser.

**B. Role of the Board of Directors**

A fund's board of directors, particularly its disinterested directors, is primarily responsible for determining whether revenue-sharing payments from the adviser to its affiliates constitute an indirect use of the fund's assets for distribution or whether they are paid out of the legitimate profits from the investment adviser's contract with the fund.<sup>166</sup> If the fund's board of directors determines that the payments are an indirect use of the fund's assets for distribution, it must ensure that the payments are made in accordance with the requirements of rule 12b-1.<sup>167</sup>

**C. Transparency of Revenue-Sharing Payments and Their Associated Costs**

As discussed below, broker-dealers are required to disclose their receipt of revenue-sharing payments to their customers that purchase fund shares. Some funds disclose details of the revenue-sharing payments made by their investment advisers to facilitate the broker-dealers' compliance with their disclosure obligation.

A broker-dealer generally is required to disclose to its customer, in writing, at or before the completion of a transaction, that it has or will receive compensation from a third party for effecting the transaction for the customer. In particular, any broker-dealer that effects a purchase of fund shares for a customer must disclose to the customer the source and amount of any revenue-sharing payments that the broker-dealer receives, or

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<sup>166</sup> *Id.*

<sup>167</sup> See Response to Question 11 for a discussion of the requirements of rule 12b-1.

will receive, from the fund's investment adviser.<sup>168</sup> A broker-dealer may satisfy this disclosure obligation by, among other things, delivering to its customer a copy of the fund's prospectus, at or before completion of the transaction, if the prospectus contains adequate disclosures.<sup>169</sup> Many funds disclose in their prospectuses information about their investment advisers' revenue-sharing payments to broker-dealers, which has the effect of facilitating the broker-dealers' compliance with that obligation. Many funds also disclose additional details about revenue-sharing payments made by their investment advisers in their SAIs.

The Commission recently has recognized, however, that fund prospectuses are not designed to make the particular disclosures that broker-dealers must provide to their customers about their receipt of revenue-sharing payments to meet the requirements of rule 10b-10 under the 1934 Act. The Commission therefore has directed its staff to make recommendations to the Commission as to whether additional disclosure should be required or current disclosure further refined.<sup>170</sup> The staff is considering whether disclosure made by the broker-dealer at the point of sale and in subsequent periodic filings would be appropriate mechanisms for this disclosure.

As discussed above, distribution related payments are made either from the fund's assets or from the resources of the fund's investment adviser. When fund assets are used to make distribution related payments, the fund generally must disclose the total amount

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<sup>168</sup> Rule 10b-10 under the Securities Exchange Act of 1934.

<sup>169</sup> See Securities Confirmations, Securities Exchange Act Release No. 13508 at n.41 (May 5, 1977). See also, Brief of the Securities and Exchange Commission, Amicus Curiae, in *Cohen, et al., v. Donaldson, Lufkin & Jenrette Securities Corp., et al.* No. 97-9159 (2d Cir.)(Feb. 2000) (the "Amicus Curiae Brief").

<sup>170</sup> See *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 132 n.13 (July 10, 2000). See also, Amicus Curiae Brief, *supra* note 169.

of expenses that it incurs for distribution, including payments from the funds' assets, and the fund must disclose that its assets are used to compensate broker-dealers for distributing the funds' shares. When fund assets are not used to make distribution related payments, *e.g.*, when the fund's investment adviser makes the payments out of its own resources, funds incur no costs and thus are not required to disclose the payments as expenses of the funds. Funds, however, are required to disclose the investment advisory fees that they pay to their investment advisers.

#### **D. Impact on Investors**

As explained above, if a fund makes payments from the fund's assets pursuant to rule 12b-1, the fund's expenses increase and the returns to the fund's shareholders are lower. If, however, a fund's investment adviser makes revenue-sharing payments out of its own resources, there generally is no direct impact on the fund and its shareholders because the payments are not made from fund assets.

Revenue-sharing payments may nonetheless affect funds and their shareholders. Investment advisory fees may be higher than they otherwise would be if no revenue-sharing payments were made. For example, an investment adviser that expects to make revenue-sharing payments for a new fund may be less willing to enter into an investment advisory agreement with the fund unless the investment advisory fee is high enough to allow the adviser to earn an acceptable profit after taking into account the anticipated revenue-sharing payments. In addition, an investment adviser that makes revenue-sharing payments for an existing fund may be less willing to agree to a reduction of its investment advisory fee because its profit already is reduced from making the payments.

Thus, in some instances, funds and their shareholders may be effectively bearing the costs of the revenue-sharing payments made by the funds' investment advisers.<sup>171</sup>

***13. Many investors select mutual funds based on past performance, although numerous studies have demonstrated that investing in funds based on past performance does not improve the likelihood of obtaining good performance going forward. Please discuss what steps can be taken to help educate investors on this subject and improve the utility of information on which fund investors base their investment decisions. Please discuss how fund advertising contributes to this phenomenon.***

Many investors consider past performance to be one of the most significant factors when selecting a mutual fund.<sup>172</sup> For many years, the Commission has taken steps to address performance advertisements that may create unrealistic investor expectations. The current rules regarding performance disclosure by mutual funds in prospectuses and advertisements are described below. In addition, performance disclosures provided by closed-end funds, unit investment trusts, investment advisers, and hedge funds are briefly summarized. Next, the Commission's concerns regarding performance advertising are discussed, as well as recent Commission initiatives intended to reinforce the antifraud protections that apply to fund advertisements and to encourage funds to use advertisements that convey balanced information to prospective investors, particularly with respect to past performance.

## **A. Current Performance Disclosures**

### **1. Current Requirements for Mutual Fund Performance Disclosure**

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<sup>171</sup> This does not necessarily mean, however, that the funds' investment advisers have violated their fiduciary duties within the scope of section 36(b) of the 1940 Act, because the advisory fees paid by the funds to their advisers may not be excessive.

<sup>172</sup> See Investment Company Institute, *Understanding Shareholders' Use of Information and Advisers* (Spring 1997), at 21 and 24 (Total return information was frequently considered by investors before a purchase, second only to the level of risk of the fund. Eighty-eight percent of fund investors surveyed said that they considered total return before their most recent purchase of a mutual fund. Eighty percent of fund owners surveyed reported that they followed a fund's rate of return at least four times per year).

The Commission has adopted rules governing performance disclosure in mutual fund prospectuses and performance advertising by mutual funds. Although market forces generally determine the amount of performance information that is made available to investors, the Commission's rules are designed to prevent misleading performance claims and to permit investors to make meaningful comparisons among fund performance claims in advertisements.<sup>173</sup>

The registration statement form for mutual funds, Form N-1A, requires funds to disclose certain performance information as part of a risk/return summary. Item 2 of Form N-1A requires the risk/return summary to include a bar chart showing the fund's annual total returns for each of the last 10 calendar years (or for the life of the fund, if shorter) and to disclose the fund's highest and lowest return for a quarter during the period of the bar chart.<sup>174</sup> Item 2 also requires the risk/return summary to include a table comparing the fund's average annual before- and after-tax total returns for the last 1-, 5-, and 10-calendar years (or for the life of the fund, if shorter) to those of a broad-based securities market index.<sup>175</sup> The bar chart is intended to illustrate graphically the variability of a fund's returns and thus provide investors with some idea of the risk of an investment in the fund. The average annual return information in the table is intended to enable investors to evaluate a fund's performance and risks relative to "the market."<sup>176</sup>

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<sup>173</sup> Investment Company Act Release No. 16245 (Feb. 2, 1988).

<sup>174</sup> Item 2(c)(2)(i) and (ii) of Form N-1A.

<sup>175</sup> Item 2(c)(2)(i) and (iii) of Form N-1A.

<sup>176</sup> Investment Company Act Release No. 23064 (Mar. 13, 1998).

Further, Item 5 of Form N-1A requires a mutual fund to include Management's Discussion of Fund Performance ("MDFP") in its prospectus or annual report.<sup>177</sup> Mutual funds generally choose to include MDFP in their annual reports. MDFP must include a discussion of the factors that materially affected the fund's performance during the most recently completed fiscal year, a line graph comparing the fund's performance over the most recently completed 10 fiscal years (or the life of the fund, if shorter) to that of a broad-based market index, and a table of the fund's average annual total returns for 1-, 5-, and 10-fiscal year periods (or the life of the fund, if shorter). The MDFP requirement is intended to provide investors with a "management's discussion and analysis" of investment performance that would give fund management an opportunity to explain the fund's investment results.<sup>178</sup>

Mutual funds are required to calculate the returns required in the risk/return summary and MDFP according to standardized formulas.<sup>179</sup> In addition, both the risk/return summary and the MDFP must include a statement to the effect that the fund's past performance is not necessarily an indication of how it will perform in the future.<sup>180</sup>

Disclosure of performance by mutual funds in advertisements is governed by rule 482 under the 1933 Act.<sup>181</sup> Rule 482 permits investment companies to advertise

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<sup>177</sup> The Commission has proposed that MDFP be in a fund's annual report. *See* Investment Company Act Release No. 25870 (Dec. 18, 2002).

<sup>178</sup> Investment Company Act Release No. 19382 (Apr. 6, 1993).

<sup>179</sup> Items 2(c)(2), 5(b)(2), and 21(b)(1), Instructions 1(a) and 2(a) to Item 2(c)(2), and Instructions to Item 9(a) of Form N-1A.

<sup>180</sup> Items 2(c)(2)(i) and 5(b)(2) of Form N-1A.

<sup>181</sup> A rule 482 advertisement is a prospectus under section 10(b) of the 1933 Act, which permits the Commission to adopt rules that provide for a prospectus that "omits in part" or "summarizes" information contained in the statutory prospectus.

investment performance data, as well as other information.<sup>182</sup> Since 1988, the Commission has required fund performance data used in advertisements to be calculated according to standardized formulas. The Commission adopted the use of standardized formulas in order to prevent misleading performance claims and to permit investors to make meaningful comparisons among fund performance claims in advertisements.<sup>183</sup>

Under rule 482, a mutual fund advertisement that includes performance information is required to include quotations of average annual total return for 1-, 5-, and 10-year periods (or the life of the fund, if shorter) computed according to standardized formulas.<sup>184</sup> Rule 482 also requires all performance data contained in any mutual fund advertisement to be as of the most recent practicable date, provided that any advertisement containing total return quotations is considered to have complied with this requirement if the total return quotations are current to the most recent calendar quarter ended prior to submission of the advertisement for publication.<sup>185</sup> In addition, rule 482 requires mutual fund performance advertisements to disclose that the performance data quoted represents past performance.<sup>186</sup>

In addition, rule 34b-1 under the 1940 Act applies to mutual fund supplemental sales literature, *i.e.*, sales literature that is preceded or accompanied by the statutory

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<sup>182</sup> Investment Company Act Release No. 25575 (May 17, 2002).

<sup>183</sup> Investment Company Act Release No. 16245 (Feb. 2, 1988).

<sup>184</sup> Rule 482(e)(3) and (5)(ii) under the 1933 Act; Item 21(b) of Form N-1A.

<sup>185</sup> Rule 482(g) under the 1933 Act.

<sup>186</sup> Rule 482(a)(6) under the 1933 Act.

prospectus required by Section 10(a) of the 1933 Act.<sup>187</sup> Under rule 34b-1, any performance data included in supplemental sales literature must be accompanied by performance data computed using the standardized formulas for advertising performance under rule 482.

Mutual fund distributors and broker-dealers who are NASD members must file all mutual fund sales material with NASD. For example, virtually all mutual fund advertisements on the television and in newspapers and magazines must be filed with NASD. NASD reviews this sales material to ensure that it is accurate, not misleading and provides a sound basis for an investment decision under Commission and NASD advertising rules. Between January 1, 2000 and December 31, 2002 NASD reviewed 189,041 items of sales material about mutual funds. These reviews represented 75% of the advertising reviews completed by NASD.

## 2. Current Performance Disclosure by Other Entities

Generally speaking, mutual funds disclose as much, if not more, information about their performance than other types of financial products or services, such as closed-end funds, unit investment trusts, investment advisers, and hedge funds. The performance disclosures provided by these entities are summarized below. Although these entities generally are not required to disclose performance data, they are subject to

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<sup>187</sup> 17 CFR 270.34b-1. Under section 2(a)(10)(a) of the 1933 Act, a communication sent or given after the effective date of the registration statement is not deemed a “prospectus” if it is proved that prior to or at the same time with such communication a written statutory prospectus was sent or given to the person to whom the communication was made.

the general antifraud provisions of the federal securities laws, and therefore any performance disclosure must comply with these provisions.<sup>188</sup>

*a. Closed-End Funds*

Closed-end funds typically do not engage in continuous offerings of their shares, but instead have an initial offering period like operating companies. Thereafter, shares of many closed-end funds are listed and traded on stock exchanges, and investors purchase shares at market price rather than at net asset value from the fund itself, as they do for mutual funds. As a result, closed-end funds, unlike mutual funds, typically do not promote their shares through performance advertisements on an ongoing basis. Closed-end fund performance disclosure has not been standardized in the way that mutual fund performance disclosure has.

Item 4 of Form N-2, the registration form for closed-end funds, requires a closed-end fund to disclose in its prospectus its beginning and ending net asset value, as well as total investment return based on market prices of the common stock, for each of the last ten fiscal years (or the life of the fund, if shorter).<sup>189</sup> Item 23 of Form N-2 requires a closed-end fund to provide this information in annual reports to shareholders for the five most recent fiscal years,<sup>190</sup> and in semi-annual reports to shareholders for the most recent fiscal year and the period of the report.<sup>191</sup> Items 4 and 23 permit, but do not

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<sup>188</sup> See, e.g., section 17(a) of the 1933 Act; section 10(b) of the 1934 Act; section 34(b) of the 1940 Act; section 206 of the Advisers Act.

<sup>189</sup> Item 4.1.a. and 4.1.g. and Instructions 3 and 13 to Item 4.1. of Form N-2.

<sup>190</sup> Instruction 4.b. to Item 23 of Form N-2.

<sup>191</sup> Instruction 5.b. to Item 23 of Form N-2.

require, a closed-end fund to disclose its total return based on net asset value.<sup>192</sup> Thus, the performance required to be disclosed pursuant to these items is based on changes in the market price of the securities issued by the closed-end fund, rather than on changes in the fund's net asset value.

*b. Unit Investment Trusts*

Unit investment trusts ("UITs") issue securities, or "units," which represent an undivided interest in a relatively fixed portfolio of securities. UITs are typically sponsored by broker-dealers, which assemble the UIT's portfolio securities, deposit the securities in a trust, and sell the units of the UIT in a public offering. There are two general types of UITs: UITs that hold fixed-income securities and UITs that hold equity securities. As contrasted with the mutual fund industry, the UIT industry is relatively small and has been declining in size during the past several years. From year-end 1991 to 2001, UIT assets under management decreased from over \$102 billion to less than \$50 billion,<sup>193</sup> as contrasted with mutual fund assets of approximately \$7.0 trillion at year-end 2001.<sup>194</sup>

UITs are not required to disclose performance information. In marketing UITs that hold fixed-income securities to investors, sponsors typically quote a rate of return that estimates the income that an investor who holds a unit for the expected life of the

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<sup>192</sup> Instruction 14 to Item 4.1 of Form N-2.

<sup>193</sup> Investment Company Institute, *MUTUAL FUND FACT BOOK* 102 (41st ed. 2001); Investment Company Institute, Statistics and Research, *UIT Statistics, Unit Investment Trust Data* (Feb. 2003) <[http://www.ici.org/ici\\_frameset.html](http://www.ici.org/ici_frameset.html)> (last visited Apr. 23, 2003). These figures do not include the assets of exchange-traded funds organized as UITs, however. As of year-end 2002, exchange-traded funds organized as UITs had \$ 66.3 billion in assets under management.

<sup>194</sup> Investment Company Institute, *MUTUAL FUND FACT BOOK* 37 (42d ed. 2002).

UIT can anticipate receiving.<sup>195</sup> This method of marketing fixed-income UITs is similar to the manner in which individual bonds are marketed to investors based on a bond's "yield to maturity,"<sup>196</sup> and may be contrasted to mutual fund performance marketing, which is based exclusively on the past performance of the mutual fund. The UIT industry has developed standardized rates of return, and the Commission staff has issued informal guidance regarding how these rates of return should be calculated.<sup>197</sup>

The sponsors or broker-dealers of UITs holding equity securities have taken multiple approaches to disclosing performance. Two approaches have been disclosure of the performance of prior portfolios of the UIT and disclosure of data that displays how the investment strategy of the trust would have performed historically.<sup>198</sup>

*c. Investment Advisers*

The federal securities laws do not require investment advisers to disclose performance data, and the Commission has not adopted standardized disclosure for advisers that elect to advertise their performance. If investment advisers choose to advertise performance information, however, the advertisements must not be false or misleading,<sup>199</sup> and advisers must maintain records necessary to substantiate their

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<sup>195</sup> Investment Company Act Release No. 21538 (Nov. 22, 1995).

<sup>196</sup> Yield to maturity is the discount rate that equates the present value of future promised cash flows from the security to the current market price of the security. William F. Sharpe *et al.*, INVESTMENTS 1028 (5th ed. 1995).

<sup>197</sup> See, e.g., *Investment Company Institute*, Division of Investment Management No-Action Letter (pub. avail. Aug. 2, 1995).

<sup>198</sup> See, e.g., Merrill Lynch Defined Asset Funds, Equity Investor Fund Select S&P Industrial Portfolio 1998 Series H, Prospectus at 5, 6 (Dec. 14, 1998) (Securities Act Release No. 64577).

<sup>199</sup> Rule 206(4)-1(a)(5) under the Advisers Act. See, e.g., *Allied Investments Co.*, Division of Investment Management No-Action Letter (pub. avail. May 24, 1979) (incomplete or inaccurate presentations by advisers of their past performance may be in violation of section 206 of the Advisers Act or rule 206(4)-1 thereunder).

performance claims.<sup>200</sup> The staff has identified a number of inappropriate advertising practices, including the following: failing to disclose the effect of material market or economic conditions on the results portrayed; including results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid;<sup>201</sup> failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; suggesting or making claims about the potential for profit without also disclosing the possibility of loss; comparing results to an index without disclosing all material facts relevant to the comparison; failing to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed; and failing to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.<sup>202</sup>

The private sector is playing a growing role in establishing performance presentation standards for advisers. In response to requirements of pension funds and other institutional clients, many investment advisers choose to follow performance presentation standards set out by the Association for Investment Management and Research ("AIMR").<sup>203</sup> Although compliance with the AIMR standards is not legally

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<sup>200</sup> Rule 204-2(a)(16) under the Advisers Act.

<sup>201</sup> The staff has provided guidance on certain circumstances where advisers may provide their performance before fee deductions, such as to sophisticated clients and to consultants. *See Investment Company Institute*, Division of Investment Management No-Action Letter (pub. avail. Sept. 23, 1988).

<sup>202</sup> *Clover Capital Management, Inc.*, Division of Investment Management No-Action Letter (pub. avail. Oct. 28, 1986).

<sup>203</sup> AIMR is a nonprofit organization that seeks to educate and examine investment managers and analysts and to sustain standards of professional conduct. Association for Investment

required, the Commission has brought enforcement actions against investment advisers for misrepresenting their compliance with AIMR standards.<sup>204</sup>

*d. Hedge Funds*

The term “hedge fund” typically refers to private investment pools that are not registered with the Commission. Hedge funds are typically sold by means of referrals and one-on-one meetings rather than through broad advertising as a result of the manner in which they are structured. To avoid regulation under the 1940 Act, hedge funds typically rely on two statutory exceptions from the definition of “investment company” in the 1940 Act. Section 3(c)(1) of the 1940 Act excepts any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which is not and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the 1940 Act excepts any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers,”<sup>205</sup> and which is not making and does not at that time propose to make a public offering of such securities. To qualify for the exceptions under these sections, and to qualify for an exemption from the registration requirements of the 1933 Act, hedge funds conduct private offerings of their shares pursuant to section 4(2) of the 1933 Act or

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Management and Research, *AIMR Description* <<http://www.aimr.com/support/about/>> (last modified Mar. 28, 2003).

<sup>204</sup> See *In the Matter of Stan D. Kiefer & Assoc. and Stanley D. Kiefer*, Investment Advisers Act Release No. 2023 (Mar. 22, 2002); *In the Matter of Schield Management Company*, Investment Advisers Act Release Nos. 1871 (May 31, 2000) and 1824 (Sept. 9, 1999); *In the Matter of Engebretson Capital Management, Inc. and Lester W. Engebretson*, Investment Advisers Act Release No. 1825 (Sept. 13, 1999).

<sup>205</sup> Section 2(a)(51) of the 1940 Act defines the term “qualified purchaser,” which generally includes natural persons who own at least \$5 million in investments, and any person, acting for its own account or the accounts of other qualified persons, who owns and invests on a discretionary basis no less than \$25 million in investments.

Regulation D. To qualify as a private offering, there can be no general solicitation of the offering and hedge funds therefore do not utilize broad advertising.

Hedge funds and their advisers are not required by statute or Commission rule to disclose performance information. As in the case of other entities discussed above, however, hedge funds are subject to the general antifraud provisions of the federal securities laws. In addition, all hedge fund advisers are subject to the antifraud provisions of section 206 of the Advisers Act. The Commission has brought enforcement actions in the hedge fund area involving the reporting of false or misleading performance information.<sup>206</sup>

## **B. Concerns Regarding Mutual Fund Performance Advertising**

Although there are many factors other than performance that an investor should consider in deciding whether to invest in a particular fund, many investors consider performance to be one of the most significant factors when selecting or evaluating mutual funds. Eager to attract new investors, many funds have, from time to time, engaged in advertising campaigns focusing on past performance. As a result of advertising that focused on extraordinary fund performance during 1999-2000, there have been increasing concerns that some funds, when advertising their performance, may resort to techniques

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<sup>206</sup> See, e.g., *SEC v. Beacon Hill Asset Management, LLC, et al.*, Litigation Release No. 17841 (Nov. 15, 2002); *SEC v. House Asset Management, LLC, et al.*, Litigation Release No. 17583 (June 24, 2002); *In the Matter of Edward Thomas Jung and E. Thomas Jung Partners, Ltd.*, Investment Advisers Act Release No. 2025 (March 28, 2002); *SEC v. Michael W. Berger, et al.*, Litigation Release No. 17230 (Nov. 13, 2001).

that create unrealistic investor expectations or may mislead potential investors. The Commission has expressed particular concerns about the following practices.<sup>207</sup>

1. Unusual Circumstances That Contribute to Fund Performance

Mutual fund performance advertisements may be materially misleading when they fail to adequately disclose that unusual circumstances contributed to the fund's advertised performance. In each of two enforcement actions, an investment adviser marketed a relatively small fund's unusually high return without disclosing that a significant percentage of the return was attributable to investments in securities issued in initial public offerings.<sup>208</sup> Given the substantial growth in the funds' assets as a result of sales of the funds' shares to the public, to the point where the funds were no longer experiencing, by investing in additional initial public offerings, substantially similar performance as they previously experienced, the Commission found that the failure to disclose the contribution to the funds' performance of the initial public offering investments was materially misleading. Along similar lines, the Commission also recently brought an enforcement action based on a fund's failure to disclose in its MDFP the material impact that investments in initial public offerings had on its performance during its previous fiscal year.<sup>209</sup>

2. Currentness of Performance Information

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<sup>207</sup> Investment Company Act Release No. 25575 (May 17, 2002).

<sup>208</sup> *In the Matter of The Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 (May 10, 2000); *In the Matter of Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Investment Advisers Act Release No. 1819 (Sept. 8, 1999).

<sup>209</sup> *In the Matter of Davis Selected Advisers-NY, Inc.*, Investment Advisers Act Release No. 2055 (Sept. 4, 2002).

As noted above, rule 482 requires all performance data contained in any mutual fund advertisement to be as of the most recent practicable date, provided that any advertisement containing total return quotations is considered to have complied with this requirement if the total return quotations are current to the most recent calendar quarter ended prior to submission of the advertisement for publication. As a result, total return quotations may be up to three months old at the time that an advertisement is submitted for publication. In some cases, an advertisement that complies with these requirements of rule 482 may nonetheless confuse, or even mislead, investors regarding the fund's current performance, particularly when the fund's performance has declined significantly after the period reflected in an advertisement.

The Commission questioned this practice in an enforcement action where it found that the failure to disclose the large impact of initial public offerings on a fund's performance during the fund's first fiscal year made the fund's performance advertisements materially false and misleading.<sup>210</sup> One of the significant facts in that case was that the fund's advertisements publicized extraordinary first-year returns at a time when the fund's more current returns had become negative.<sup>211</sup> While the fund advertisements complied with rule 482, the Commission noted that rule 482 advertisements remain "subject to the general antifraud provisions of the federal securities laws and must not be false or misleading."<sup>212</sup> In another recent enforcement

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<sup>210</sup> *In the Matter of The Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 (May 10, 2000).

<sup>211</sup> *Id.* (81.92% total return for the one-year period ended September 30, 1996, publicized in October through December 1996 when total returns for the three-month periods ended August 30, September 30, October 31, November 29, and December 31, 1996, were negative 17.03%, 7.71%, 7.79%, 16.25%, and 13.37%, respectively).

<sup>212</sup> *Id.* at n.16.

action, the Commission determined that a fund's advertisements were materially misleading where they did not comply with the requirement of rule 482 that historical performance information be current to the most recent calendar quarter ended prior to the submission of the advertisement for publication. As of December 2000, the fund's website advertised a total return of 422% from inception to March 10, 2000, but the fund's total returns since inception had declined to 191% by September 30, 2000, the end of the most recent quarter.<sup>213</sup>

### 3. Selective Use of Performance Figures

A mutual fund advertisement may be materially misleading when it showcases a fund's performance for a certain time period without providing sufficient information to permit an investor to evaluate the significance of the performance data. As noted above, rule 482, by its terms, permits a mutual fund to advertise its performance for any period so long as it is accompanied by performance for 1-, 5-, and 10-year periods (or, if shorter, for the life of the fund) current to the most recent quarter. Nonetheless, if a fund selectively advertises performance that is unusually high and not representative of the fund's historical performance, investors may potentially be misled. Selectively advertising performance as of a particular date may be particularly problematic where performance has declined after the chosen date but before the advertisement is submitted for publication.

## **C. Commission Initiatives to Address Mutual Fund Performance Advertising Concerns**

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<sup>213</sup> *In the Matter of The Thurlow Funds, Inc., Thurlow Capital Management, Inc., and Thomas F. Thurlow*, Investment Advisers Act Release No. 2065 (Oct. 2, 2002).

The Commission has taken steps to address these concerns, including proposing rules regarding fund advertisements and promoting investor education.

1. Proposed Rules

In May 2002, the Commission proposed amendments to its mutual fund advertising rules that would require enhanced disclosure in fund advertisements and are designed to encourage advertisements that convey balanced information to prospective investors, particularly with respect to past performance.<sup>214</sup> These proposed amendments would re-emphasize that fund advertisements are subject to the antifraud provisions of the federal securities laws, require that funds that advertise performance information make available to investors total returns that are current to the most recent month-end, and require that fund advertisements include improved explanatory information and present this information more prominently.

First, the Commission's proposals would re-emphasize that fund advertisements are subject to the antifraud provisions of the federal securities laws. In order to emphasize this principle, the proposals would add a note to rule 482 that would state that an advertisement that complies with rule 482 does not relieve the fund, underwriter, or dealer of the obligation to ensure that the advertisement is not false or misleading and would add a similar note to rule 34b-1 under the 1940 Act with respect to supplemental sales literature. In addition, the Commission's proposals would modify the language of rule 156 under the 1933 Act, which provides guidance on the types of information that could be misleading in fund sales literature, to state more explicitly that portrayals of past income, gain, or growth of assets may be misleading where the portrayals omit

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<sup>214</sup> Investment Company Act Release No. 25575 (May 17, 2002).

explanations, qualifications, limitations, or other statements necessary or appropriate to make these portrayals of past performance not misleading.<sup>215</sup> This language is intended to address the Commission's concerns with fund performance advertisements that do not provide adequate disclosure (i) of unusual circumstances that have contributed to fund performance; (ii) that more current performance may be lower than advertised performance; or (iii) that would permit an investor to evaluate the significance of performance that is based on selective dates.

Second, in order to address concerns about the currentness of performance information, the Commission's proposals would add an additional condition for a fund advertisement to be considered to have complied with the requirement of rule 482 that performance be as of the most recent practicable date.<sup>216</sup> Specifically, total return quotations current to the most recent month-end would have to be provided at a toll-free (or collect) telephone number. As a result, investors who are provided advertisements touting a fund's performance would have ready access to performance that is current to the most recent month-end and would not be forced to rely on performance data that may be more than three months old at the time of use by the investor.

Third, the Commission's proposals include changes to the explanatory information that is required to accompany performance advertisements in order to help investors understand the limitations of past performance data and enhance the ability of investors to obtain updated performance information.<sup>217</sup> The Commission's proposals

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<sup>215</sup> Rule 156 applies to all fund advertisements and supplemental sales literature.

<sup>216</sup> Investment Company Act Release No. 25575 (May 17, 2002).

<sup>217</sup> *Id.*

would require funds to include the following information in rule 482 advertisements that include past performance figures: (i) a statement that past performance does not guarantee future results, (ii) a statement that current performance may be lower or higher than the performance data quoted, and (iii) a toll-free (or collect) telephone number and, if available, website where an investor may obtain performance data current to the most recent month-end. In addition, the proposals would require a fund to note in its rule 482 advertisements that information about charges and expenses is contained in the fund's prospectus. This requirement should help to address concerns that advertisements highlighting fund performance may cause investors to overlook the importance of fund costs.

Fourth, the Commission's proposals would require funds to present certain information in their rule 482 advertisements more prominently.<sup>218</sup> For example, the proposals would require that the narrative disclosures that specifically relate to fund performance be presented in close proximity to the performance data in both print and radio and television advertisements. This proximity requirement is intended to help investors more readily find information necessary to understand and evaluate the performance data shown.

Overall, the proposed amendments to the fund advertising rules are an integral part of the Commission's continuing efforts to raise the bar for fund performance advertising so that investors are informed, and not misled, by that advertising. We expect shortly to recommend to the Commission adoption of amendments to the advertising rules.

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*Id.*

## 2. Investor Education

In addition to rulemaking initiatives, the Commission has engaged in education efforts to caution investors against the dangers of overemphasizing fund performance in investment decisions. For example, the Commission published an investor alert on its website that explains to investors the importance of looking beyond past performance in making investment decisions.<sup>219</sup> The investor alert emphasizes that the long-term success (or failure) of a mutual fund investment also depends on factors such as the fund's sales charges, fees, and expenses; the taxes investors may have to pay when they receive distributions; the age and size of the fund; the fund's risks and volatility; and recent changes in the fund's operations.

NASD also has published notices and other reminders to members concerning the application of the advertising rules to mutual fund performance. In recent years, there have been two notices that addressed the overstatement of mutual fund performance. An article in the Summer 1999 edition of the NASD Regulatory and Compliance Alert directed member firms to amend their historical performance communications if the advertised fund has experienced abrupt negative performance since the advertisement was developed. This requirement forces members to include information beyond the minimum standards of performance disclosure. The second notice was included in NASD Notice To Members 00-21 (April 2000). This notice reminded broker-dealers that if they prominently advertise their extraordinarily high mutual fund performance, they

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<sup>219</sup> See Securities and Exchange Commission, *Mutual Fund Investing: Look at More Than a Fund's Past Performance* <at <http://www.sec.gov/investor/pubs/mfperform.htm>> (last modified Jan. 24, 2000).

also must explain what conditions led to that performance and the risks that the advertised mutual fund will not achieve similar performance in the future.

#### **D. Additional Suggestions for Improvement of Performance Disclosure**

Some have suggested that fund families be required to disclose the average performance of all their funds, including the performance of funds no longer in existence.<sup>220</sup> The Commission's regulations neither require funds to disclose their performance on a complex-wide basis, nor do they specifically prohibit funds from doing so.<sup>221</sup> Supporters of complex-wide performance have argued that this disclosure would provide investors with a more accurate picture of the performance achieved by fund families because it would include the aggregate performance data of all funds managed by the family and not only those that are currently in existence. These supporters argue that, in marketing a new fund, fund families may initially create a number of funds with the same strategy, and after a year will advertise the performance of the most successful fund and will liquidate or merge the others. Arguably, requiring disclosure of the

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<sup>220</sup> *Mutual Fund Industry Practices and their Effect on Individual Investors: Hearings Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Comm., 108th Congress (2003) (testimony of Gary Gensler).*

<sup>221</sup> Most fund marketing materials are required to be filed with and reviewed by NASDR, the independent subsidiary of the NASD, a self-regulatory organization authorized by the Commission under the 1934 Act. NASDR takes the position that aggregated performance must not be used with the general public. See "Blended Fund Family Performance Concerns NASD Regulation, Inc.," NASD Regulatory and Compliance Alert Articles, Oct. 1996.

performance of an entire fund family would illuminate this survivorship bias<sup>222</sup> and would benefit investors who are trying to decide among different mutual fund families.<sup>223</sup>

This suggestion presents several practical issues. For example, as in the case of individual mutual funds, the past performance of a fund family would not necessarily be indicative of the performance that it would achieve in the future. In addition, the investment objectives, strategies, and risks of funds managed by fund families vary widely and therefore the value of comparisons among families could be limited. Thus, to facilitate useful comparisons among fund families, it might be necessary to disclose performance by fund category (*e.g.*, high-yield bond funds, growth stock funds) within each fund family. Placing mutual funds into defined categories, however, could present complex issues because of the numerous potential combinations and definitions of mutual fund objectives and strategies, as well as the potentially subjective nature of any determination made by a fund family in categorizing its funds.

We also note that some fund groups prepare promotional materials that list the individual returns of all of the funds within a complex. The exclusion of the performance of funds that have been liquidated or merged out of existence could suggest that the overall performance of all of the funds in the same complex during the relevant period was better than it actually was if the performance of the excluded funds was sub-standard. We have not specifically studied the effect, if any, that incubator funds and survivorship bias may have on investor perceptions. Anecdotal evidence suggests that

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<sup>222</sup> The term “survivor bias” as it relates to complex-wide performance would be the effect of excluding, from a presentation of the complex-wide fund performance, the performance of funds that have liquidated or merged out of existence during the relevant period.

<sup>223</sup> *Mutual Fund Industry Practices and their Effect on Individual Investors*: Hearings Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Comm., 108th Congress (2003) (testimony of Gary Gensler).

many investors choose to invest in a fund based on that fund's past performance and not on the performance of all the funds in the same complex.

Because the NASD does not permit the use of aggregated fund family performance in advertising and sales material, any survivorship bias would be a product of how this information is reported by third party fund tracking entities.

***14. Please discuss whether shareholder reports, on average, adequately disclose the factors affecting fund performance.***

Generally, we examine disclosure concerning fund management's discussion of the fund's performance in reports to shareholders as part of our "integrated review" program. In that program, we compare what the fund says it will do (generally speaking, in the prospectus), with what it says it did (generally speaking, in management's discussion of the fund's performance in the annual report and in other publicly available information). We then analyze whether a fund is complying with the objectives and strategies set forth in its prospectuses. When we identify issues in this area, we contact the fund and, in appropriate circumstances, urge the fund to change its prospectus disclosures. In more unusual circumstances, the staff may refer the fund to our Office of Compliance Inspections and Examinations for inspection.

In addition, in early 2003, the staff conducted a targeted review of shareholder reports in which we focused on the quality of management discussions of fund performance in connection with proposed rules that would modify fund annual reports. We looked at funds from large and small fund complexes, as well as a mix of more-established and newer funds.

Most of what we saw was either of good or average quality. The better discussions provided relatively detailed explanations of general economic and market

conditions, and specifically tied those explanations to how they affected performance. These funds also had specific disclosure regarding particular fund strategies and identified major portfolio holdings, and discussed how those strategies and holdings affected performance. The better disclosures for equity funds often addressed exposures to particular market sectors or industries; the better disclosures for debt funds often addressed maturity and duration issues.

The poorer quality disclosures typically failed to specifically address how the funds' specific investment choices and strategies affected performance. Rather, these funds typically provided general "laundry-lists" of world events to explain their performance. While a discussion of general economic factors and world events often is necessary, there nevertheless should be a discussion of how those factors and events impacted the particular fund(s). In the case of newer funds, we sometimes did not see discussions of the impact of fee waivers on performance where such a discussion would have seemed appropriate. Many funds, especially new funds, waive all or a portion of their operating expenses. Some funds set contractual caps on expenses at a lower level for a stated period of months or years, while others have no set time period. When the waiver has a significant impact on performance, the staff believes that those funds should discuss their impact in fund reports.

We also noticed a disparity between some of the presentations for "multi-series" funds. The better ones usually set forth a general discussion of the markets and world events, told the reader to read on for discussions for each fund, and then provided specific analysis of why each fund performed the way it did (repeating as necessary the discussion of general factors and events where they were relevant to a particular fund). Other

presentations were less readable: either because the general discussions were too lengthy and/or not tied to specific funds, or because the fund tried to group the general and specific discussions in such a way that it was hard to determine which fund was being talked about at any one point.

We will continue to conduct our integrated review program to improve disclosure in this area, along with meeting new requirements under the Sarbanes-Oxley Act regarding the review of investment company financial statements and periodic filings.

***15. Please discuss the practice of steering hot IPOs to “incubator” funds and then using those funds’ performance data as a marketing tool.***

**A. General Characteristics of Incubator Funds**

An incubator fund is an investment vehicle that an investment adviser establishes to, among other things, test investment techniques and create a performance record. Initially, an incubator fund is lightly capitalized and typically is not marketed to the public. The investors in the incubator fund may be, for instance, insiders of the investment adviser and/or certain of the adviser’s clients. If the incubator fund achieves strong performance, the investment adviser typically will market the fund to the public. If the marketing is successful, the fund’s assets will increase and, as a result, the investment advisory fee revenues to the investment adviser also will increase.

An investment adviser may establish several incubator funds to test several different investment techniques. After waiting a period of time (an incubation period), the investment adviser may select the incubator funds with the best performance and market them to the public, using the funds’ performance as a marketing tool. The investment adviser typically liquidates the other incubator funds.

## **B. Regulation of Incubator Funds**

During its incubation period, an incubator fund may be structured and operated in reliance on exceptions from regulation as an investment company under the 1940 Act and registration of securities offerings under the 1933 Act.<sup>224</sup> The Commission does not regulate those incubator funds, although the antifraud provisions of the federal securities laws apply to their operation and to the offer and sale of their shares. Some incubator funds may register with the Commission as investment companies, but refrain from marketing themselves to the public during their incubation period. The Commission regulates those funds as investment companies, and they must comply with all of the provisions of the 1940 Act. Regardless of whether or not an incubator fund is registered with the Commission, the use of the incubator fund's prior performance to market the fund is subject to the antifraud provisions of the federal securities laws.

## **C. Steering Hot IPOs**

The term "hot IPOs" generally refers to initial public offerings of securities that are in great demand, of limited availability, and for which trading is expected to occur in the immediate aftermarket at a significant premium to the initial offering price ("hot IPO securities"). Hot IPO securities are valuable investment opportunities, of limited quantity and temporary duration. An investment adviser must allocate hot IPO securities among its clients in a manner that is consistent with the investment adviser's fiduciary duties to its clients and with its disclosures to its clients. An investment adviser could defraud its clients by preferring incubator funds in the allocation of hot IPO securities. The

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<sup>224</sup> See sections 3(c)(1) and 3(c)(7) of the 1940 Act; section 4(2) of the 1933 Act and regulation D thereunder.

Commission has instituted several enforcement actions against investment advisers for fraudulently allocating hot IPO securities.<sup>225</sup>

During the time that an incubator fund is lightly capitalized, its performance may be significantly affected by the positive returns of a few of its portfolio securities, such as hot IPO securities. After the incubation period, however, when an incubator fund is marketed to the public and has an increased asset base (the “post-incubation period”), the fund likely may not continue to experience, by investing in hot IPO securities, substantially similar performance. For instance, during the post-incubation period, hot IPO securities may not be available to the investment adviser in sufficient quantities to maintain the positive results that the fund experienced when its asset base was smaller.

**D. Using Incubator Fund Performance as a Marketing Tool, and Specific Disclosures Regarding Incubator Funds**

Incubator funds may typically use their performance information as a marketing tool to raise capital from the public. The marketing of incubator funds, however, is subject to the antifraud provisions of the federal securities laws.<sup>226</sup> Whether incubator fund performance information is presented in a false or misleading manner depends on all of the facts and circumstances relating to its presentation.

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<sup>225</sup> See, e.g., *In the Matter of F.W. Thompson Co., Ltd. and Frederick W. Thompson*, Investment Advisers Act Release No. 1895 (Sept. 7, 2000); *In the Matter of McKenzie Walker Investment Management, Inc. and Richard C. McKenzie, Jr.*, Investment Advisers Act Release No. 1571 (July 16, 1996); *In the Matter of Account Management Corporation, Peter De Roeth and Richard C. Albright*, Investment Advisers Act Release No. 1529 (Sept. 29, 1995).

<sup>226</sup> See section 34(b) of the 1940 Act and rule 34b-1 thereunder, section 10(b) of the 1934 Act and rule 10b-5 thereunder, section 17(a) of the 1933 Act and section 206 of the Advisers Act. See also rule 156 under the 1933 Act.

The Commission has instituted enforcement actions against investment advisers of incubator funds for their use of misleading incubator fund performance information.<sup>227</sup> In those actions, the incubator funds and their investment advisers marketed the funds and their performance to the public without disclosing that (a) a substantial portion of the funds' performance was attributable to investing in hot IPO securities and, (b) given the growth in the funds' assets, it was questionable whether the funds could continue to experience, by investing in hot IPO securities, substantially similar performance as previously experienced.

In addition, if an investment adviser establishes several incubator funds to generate performance track records, but selects only the best performing incubator fund to market to the public, it may be misleading for the fund to present its performance information without also clearly disclosing the performance information of the other, less successful incubator funds.<sup>228</sup>

***16. Please discuss the legal and policy implications of the potential use of mutual funds by their broker-dealer affiliates to prop up prices of IPOs in the secondary market.***

A broker-dealer that is an affiliated person of a fund would violate the federal securities laws if it used the fund's assets to prop up the prices of IPO securities in the

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<sup>227</sup> See, e.g., *In the Matter of Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Investment Advisers Act Release No. 1819 and Investment Company Act Release No. 23996 (Sept. 8, 1999) <<http://www.sec.gov/litigation/admin/ia-1819.htm>>; *In the Matter of Dreyfus Corporation and Michael L. Schonberg*, Investment Advisers Act Release No. 1870 and Investment Company Act Release No. 24450 (May 10, 2000) <<http://www.sec.gov/litigation/admin/33-7857.htm>>. See also, *In the Matter of Davis Selected Advisers-NY, Inc.*, Investment Advisers Act Release No. 2055 and Investment Company Act Release No. 25727 (Sept. 4, 2002) (<http://www.sec.gov/litigation/admin/ia-2055.htm>).

<sup>228</sup> See generally, Stern School of Business (pub. avail. Feb. 3, 1997).

secondary market for the benefit of the broker-dealer. Such conduct would raise the exact concerns that the 1940 Act was designed to address.<sup>229</sup>

As a practical matter, a broker-dealer could have the ability to use fund assets to benefit itself if the broker-dealer was itself the fund's investment adviser, or if the broker-dealer controlled or was under common control with the fund's investment adviser.<sup>230</sup> A broker-dealer could have an incentive to prop up the price at which IPO securities trade in the secondary market if the broker-dealer acted as an underwriter of the securities during their initial public offering ("affiliate underwritten securities"). In particular, a significant decrease in the secondary market price of a security underwritten by a broker-dealer might reflect poorly on the underwriter, hurting its reputation and its future business prospects.

Various provisions of the 1940 Act apply when a fund's assets are used to prop up the price of affiliate-underwritten securities in the secondary market or during an IPO. For instance, section 10(f) of the 1940 Act generally prohibits a fund from purchasing securities during the existence of any underwriting or selling syndicate in which a fund

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<sup>229</sup> Section 1(b)(2) of the 1940 Act provides that:

[t]he national public interest and the interest of investors are adversely affected when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers...rather than in the interest of all classes of such company's security holders.

<sup>230</sup> Such a broker-dealer would be an affiliated person of the fund as defined in section 2(a)(3) of the 1940 Act. Under section 2(a)(3)(C) of the 1940 Act, an affiliated person of another person includes any person directly or indirectly controlling, controlled by, or under common control with, such other person. In so far as a fund is controlled by its investment adviser, a broker-dealer that is controlled by, or under common control with, the investment adviser would also be under common control with the fund. Under section 2(a)(3)(E) of the 1940 Act, a fund's investment adviser is an affiliated person of the fund.

affiliate acts as a principal underwriter.<sup>231</sup> Section 10(f) was designed primarily to prevent an underwriter from “dumping” securities on an affiliated fund, *i.e.*, placing securities with the fund in order to stimulate the market in the securities or to relieve the underwriting syndicate or a member thereof of securities that are otherwise unmarketable.<sup>232</sup> Section 10(f) would prohibit a fund from purchasing an affiliate underwritten security in the secondary market if any underwriting or selling syndicate in which the broker-dealer acts as principal was still in existence.<sup>233</sup>

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<sup>231</sup> In connection with a distribution of securities, Rule 101 of Regulation M of the Securities Exchange Act of 1934 states that it shall be unlawful for a distribution participant or an *affiliated purchaser* of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase a covered security during the applicable Regulation M restricted period absent an exception or exemption. To the extent that a fund affiliated with an underwriter is an "affiliated purchaser" of the underwriter for purposes of Regulation M, the fund would be subject to Regulation M and may be prohibited from purchasing the covered security or any reference security during the applicable restricted period.

<sup>232</sup> See Hearings Bef. Subcomm. of the Comm. On Banking and Currency on S. 3580, 76<sup>th</sup> Cong., 3d Sess. 35, 209-213 (1940). In its study of the fund industry prior to 1940, the Commission discussed examples of situations in which underwriters had used assets of their affiliated funds to benefit the underwriters or to save them from insolvency. See *generally*, Securities and Exchange Commission, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76<sup>th</sup> Cong., 1<sup>st</sup> Sess., pt. 3, at 2519-2624 (1939). The Commission explained:

The control of [a fund] by an investment banker naturally impresses the client, who desires to be financed, with the resources that the investment banker may call upon to make the financing operation successful, such as, selling some of the securities to the [fund], securing the [fund's] participation in the underwriting commitment, including the [fund] in trading accounts or using the [fund's assets] in stabilizing the market.

*Id.* at 2535-36.

It is important to note that "securities acquired in a distribution for investment purposes by anyone participating in the distribution, or any affiliated purchaser, are considered to distributed" for purposes of Regulation M. Exchange Act Release No. 38067 (Dec. 26, 1996), (Adopting Release). Thus, securities would not be considered distributed for purposes of Regulation M and the distribution would continue if an affiliate fund, that is an affiliated purchaser of an underwriter under Regulation M, acquires securities in a distribution but does not acquire the securities for investment purposes.

<sup>233</sup> Notwithstanding section 10(f), rule 10f-3 under the 1940 Act provides conditional relief from the prohibitions of section 10(f). The conditions relate to, among other things, the types and amounts of securities that a fund may purchase under the rule, and the timing of and prices of those purchases. The rule balances the benefits to funds in purchasing certain affiliate underwritten securities against the possibility that the fund's assets would be used to benefit an affiliated person of the fund.

Under certain circumstances, section 17(d) of the 1940 Act and rule 17d-1 thereunder may prohibit a fund's purchase of affiliate underwritten securities in the secondary market. Section 17(d) and rule 17d-1 generally prohibit any affiliated person of a fund, acting as principal, from effecting any joint arrangement, or profit sharing plan, with the fund.<sup>234</sup> Those provisions, taken together, are designed to regulate situations in which persons making the investment decisions for a fund may have a conflict of interest and the danger exists that the fund may be overreached by the affiliated persons.<sup>235</sup>

A fund's investment adviser may defraud the fund and its shareholders if it causes the fund to purchase affiliate underwritten securities in the secondary market for the benefit of the adviser or an affiliated person of the adviser. An investment adviser has a fiduciary duty to act in the best interests of its clients, and to disclose to clients all material conflicts of interest.<sup>236</sup> The possibility that an investment adviser or its affiliated person could benefit from a transaction that is undertaken by a fund at the direction of the

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<sup>234</sup> Section 17(d) of the 1940 Act provides that the Commission may adopt certain rules restricting participation by registered investment companies in joint transactions with affiliated persons. Rule 17d-1, in relevant part, provides that no affiliated person of a registered investment company, may participate as a principal in any joint enterprise as defined in the rule, without first obtaining an order from the Commission. Rule 17d-1(c) defines a "[j]oint enterprise or other joint arrangement or profit-sharing plan" to include any contract or arrangement concerning an enterprise or undertaking whereby an investment company and an affiliated person of the company "have a joint or joint and several participation, or share in the profits of such enterprise or undertaking." Some element of combination or profit motive generally must be present for section 17(d) and rule 17d-1 to apply. *See In re Steadman Security Corp.*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,038 at 84,848 (Dec. 20, 1974) and *SEC v. Talley Indust., Inc.*, 399 F.2d 396, 403 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969).

<sup>235</sup> *See* Testimony of David Schenker, Hearings Before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, on S. 3580 (76th Cong., 3rd Sess.) 256 (Apr. 19, 1940) (stating that the purpose of section 17(d) (originally drafted as section 17(a)(4)) is to "ensure fair dealing and no overreaching").

<sup>236</sup> *See* section 206 of the Advisers Act (advisers prohibited from engaging in practices that defraud or operate as a fraud or deceit upon any client or prospective client). *See also*, section 36(a) of the 1940 Act (authorizes the Commission to sue fund directors and fund advisers, among others, for "any act or practice constituting a breach of fiduciary duty involving personal misconduct").

adviser may, depending on the circumstances, present a material conflict of interest for the investment adviser. In that event, the investment adviser generally would have a fiduciary obligation to disclose its conflict of interest to the fund's board and, in particular, to the fund's independent directors, and to obtain their consent before proceeding with the transaction.<sup>237</sup> A fund's directors would have to weigh the benefits to the fund in making the proposed investment against the possible benefits to the fund's investment adviser and its affiliated persons. The directors could determine, after full disclosure of all of the relevant material facts, that the fund should purchase the affiliate underwritten securities. The fund could do so, provided that the purchase did not otherwise violate sections 10(f) or 17(d) of the 1940 Act.

***17. I congratulate the Commission once again for adopting new rules requiring disclosure of mutual fund proxy voting. I am concerned, however, by industry efforts to block the implementation of this important reform by intervening in the OMB's routine review of the rules. Please provide the Commission's analysis of whether the benefits to investors of this enhanced transparency merit the burdens and costs to industry, and an estimation of what those burdens and costs will be.***

#### **A. Background**

On January 31, 2003, the Commission adopted new rules that require a mutual fund to file with the Commission an annual report on new Form N-PX, containing the fund's complete proxy voting record for the twelve-month period ending June 30, by no later than August 31 of each year.<sup>238</sup> The rules require a fund to make this proxy voting record available to shareholders either upon request or by making available an electronic version on the fund's website. The rules also require a fund to disclose in its SAI the

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<sup>237</sup> *Tannenbaum v. Zeller*, 552 F.2d 402 (2<sup>nd</sup> Cir. 1977).

<sup>238</sup> Investment Company Act Release No. 25922 (Jan. 31, 2003).

policies and procedures that it uses to determine how to vote proxies relating to portfolio securities. Finally, the rules require a fund to disclose in its annual and semi-annual reports to shareholders and in its SAI the methods by which shareholders may obtain information about proxy voting.

When it adopted the new rules, the Commission submitted new Form N-PX to the Office of Management and Budget (“OMB”) for review under the Paperwork Reduction Act of 1995, and also requested comments on the Commission’s estimate of the paperwork burden with respect to Form N-PX. OMB and the Commission received several comments on the paperwork burden estimate, including comment letters from fund industry participants, and OMB approved the collection of information for new Form N-PX on March 28, 2003.

In designing the new proxy voting disclosure requirements, the Commission was extremely sensitive to the potential costs to the fund industry and fund investors and took steps to minimize these costs. As proposed, the proxy voting disclosure rules would have required a fund to disclose its proxy voting record as part of its annual and semi-annual reports on Form N-CSR in order to avoid burdening funds with an additional filing.<sup>239</sup> A fund would have been required to provide this information to a shareholder upon request, in order to avoid imposing on funds unnecessary costs that would be associated with the distribution of proxy voting information to every shareholder of a fund.

In response to concerns expressed about costs by commenters, the Commission modified its proposed proxy voting disclosure rules upon adoption in three significant ways. First, the final rules require a fund to file its complete proxy voting record

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<sup>239</sup> Investment Company Act Release No. 25739 (Sept. 20, 2002).

annually for the year ended June 30, rather than semi-annually based on the fund's own fiscal year-end. This modification was intended to address concerns that, under the proposed rules, fund complexes that have staggered fiscal year ends for different funds would have been required to file reports containing proxy voting records as many as twelve times per year. Second, rather than requiring a fund to send its proxy voting record to any requesting shareholder, the final rules permit a fund to make its proxy voting record available to shareholders on the fund's website. Third, the Commission determined not to adopt a proposed requirement that a fund disclose in its annual and semi-annual reports to shareholders proxy votes that are inconsistent with the fund's proxy voting policies and procedures. This modification was intended, in part, to address commenters' concerns that the disclosure of inconsistent votes would have been burdensome because it would have required funds to analyze a large volume of proxy votes to determine whether any vote triggered the disclosure and then to provide a lengthy explanation to shareholders regarding each inconsistent vote.

## **B. Cost-Benefit Analysis**

In its release adopting the new proxy voting disclosure rules, the Commission provided the following analysis of the benefits and costs of the rules.

### **1. Benefits**

The Commission's cost-benefit analysis stated that the new rules would have several benefits. First, the rules would provide better information to investors who wish to determine to which fund managers they should allocate their capital, and whether their existing fund managers are adequately maximizing the value of their shares. Second, the rules may deter voting decisions that are motivated by consideration of the interests of the

fund's adviser rather than the interests of the fund shareholders. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund, so that the adviser may have an incentive to support management recommendations to further its business interests. Third, the rules provide stronger incentives to fund managers to vote their proxies conscientiously, and thereby could improve corporate performance and enhance shareholder value.

The cost-benefit analysis did not quantify these benefits. However, the Commission noted that while measuring the effects of such a rule involves a high degree of uncertainty, the scale of the aggregate portfolio holdings involved suggests that they may be substantial. The Commission noted that assets held in equity funds account for approximately 18% of the \$11 trillion market capitalization of all publicly traded U.S. corporations.<sup>240</sup>

## 2. Costs

In its cost-benefit analysis, the Commission also recognized that the new rules would lead to some additional costs for funds, which may be passed on to fund shareholders. The Commission noted that the components of the direct costs of the new disclosure requirements include both internal costs (for attorneys and other non-legal staff of a fund, such as computer programmers, to prepare and review the required disclosure) and external costs (for typesetting, printing, and mailing of the disclosure). The Commission estimated that the total direct costs of the additional disclosure required by the new rules would be approximately \$12,700,000 annually. The Commission based

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<sup>240</sup> Board of Governors of the Federal Reserve System, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, THIRD QUARTER 2002, at 90 (2002).

its cost estimates on the costs of funds that currently provide this disclosure, estimates of the average number of portfolio holdings of equity funds, and estimates of the average number of issues voted on at a typical shareholder meeting. The Commission noted that because the new rules may have the effect of inducing fund advisers and fund boards to devote more resources to articulating their proxy voting policies and procedures in more detail, and to monitoring proxy voting decisions, they may result in higher expenses and advisory fees for funds.

In the adopting release, the Commission also addressed arguments by opponents of the rules that the rules may impose indirect costs on fund managers. First, these commenters argued that depriving funds of confidential voting would subject them to possible retaliatory actions by corporate management of the issuers of portfolio securities, such as restricting access by portfolio managers to corporate personnel. The Commission noted, with respect to this argument, that the commenters did not provide any evidence that this retaliatory action had occurred or might occur as a result of proxy vote disclosure. It also noted that while it is possible that corporations could retaliate against fund managers if they knew that those fund managers had voted against them in the past, it is also possible that corporations could react by trying to work harder to develop cooperative relationships with fund managers.

Second, commenters argued that requiring disclosure of proxy voting records would politicize the process of proxy voting, and would detract from a fund's ability to concentrate on the management of its portfolio. In response to this argument, the Commission noted that to the extent that fund managers may be pressured by large or influential shareholders to vote as directed, making voting policies and procedures

available to investors will mitigate this influence to a large degree. Because of the disclosure requirements in the new rules, shareholders will be able to evaluate how closely fund managers follow their stated proxy voting policies and to react adversely to fund managers who vote inconsistently with these policies.

We note that some Commissioners wanted to make certain the staff continued to monitor the costs of complying with the rule to ensure that there were no unintended consequences. Consequently, as noted in the adopting release, the Commission asked the staff to monitor the effects of the disclosure and report back to the Commission within two years on the operation of the rule.<sup>241</sup>

***18. The Commission staff recently indicated that it would recommend enforcement proceedings against a mutual fund company for failing to properly value private holdings of the firm's mutual funds. Please discuss the issues raised by portfolio security valuation methodologies and the relevant rules relating to those methodologies. In particular, please discuss the rules applicable to, and issues raised by, valuation of private securities as well those relating to fair value pricing of securities for which a market price is available. Please discuss the extent to which pricing is done by third-party, arms' length independent appraisers and how the discount for large-bloc positions is determined.***

Mutual funds must accurately value their portfolio securities and calculate their net asset values ("NAV") to ensure that mutual fund shareholders are treated fairly. If a fund's shares are overvalued, redeeming shareholders will receive a windfall at the expense of shareholders that remain in the fund, and purchasing shareholders will pay too much for their shares. Similarly, if a fund's shares are undervalued, redeeming shareholders will receive too little for their shares, and purchasing shareholders will pay too little for their shares. Accurate valuations are important for another reason: many

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Investment Company Act Release No. 25922 (Jan. 31, 2003)

fund expenses, including investment advisory fees, are typically calculated as a percentage of NAV.

The 1940 Act generally requires mutual funds to calculate their NAV by using the market value of their portfolio securities when market quotations for those securities are readily available.<sup>242</sup> For example, for securities that trade on exchanges, over-the-counter markets, or other active markets, funds must use prices from those markets to value the securities, except when market quotations for the securities are not readily available. In that case, the 1940 Act requires mutual funds to calculate their NAV by using the “fair value” of their portfolio securities, as determined in good faith by the funds’ boards of directors.<sup>243</sup>

As the Commission has previously stated, there is no single standard for determining fair value because fair value depends on the circumstances of each individual situation. As a general principle, however, the fair value of a portfolio security is the amount that a fund might reasonably expect to receive upon a current sale of the security to a willing buyer in an arm’s length transaction.<sup>244</sup>

In ascertaining the fair value of a security, a fund’s board of directors should review all appropriate factors and take into account all indications of value available to them. Among the general factors that a fund’s board of directors may wish to consider are fundamental analytical information about the security, restrictions on the security’s

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<sup>242</sup> Section 2(a)(41)(B) of the 1940 Act. The Act generally requires funds to compute their NAVs at least once daily, Monday through Friday, at a specific time or times as determined by their board of directors. Rule 22c-1(b) under the 1940 Act. Rule 22c-1(a) requires mutual funds to sell and redeem their shares at the NAVs next computed after receipt of an order.

<sup>243</sup> Section 2(a)(41)(B) of the 1940 Act.

<sup>244</sup> Accounting Series Release No. 118, Financial Reporting Codification (CCH) §404.03 (Dec. 23, 1970) (“ASR No. 118”).

disposition, and factors bearing on the market for a particular security. Other more specific factors that may be relevant to the fair value price of a security include the type of security, size of the holding, and cost. Whether any particular factor is “appropriate,” and whether a particular indication of value is available, depends upon the particular facts and circumstances of the situation.<sup>245</sup>

The fair value of a restricted security, *i.e.*, a security that has been issued in a transaction not involving a public offering, depends on its “inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature.” Consequently, funds generally may not fair value a restricted security at the market value of an unrestricted security of the same class as the restricted security, nor may funds continue to fair value a restricted security at its cost if cost no longer represents fair value as a result of issuer-specific, market-related, or other events. In addition, funds generally may not fair value a restricted security by applying a uniform discount calculated by reference to the market quotation for an unrestricted security of the same class.<sup>246</sup>

In certain circumstances, market quotations of certain portfolio securities, while available, may be unreliable. For example, if sales of a portfolio security have been infrequent or if there is a thin market in the security, market quotations may not be readily available. If market quotations are not readily available for a portfolio security,

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<sup>245</sup> *Id.* See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Dec. 8, 1999).

<sup>246</sup> See Accounting Series Release No. 113, Financial Reporting Codification (CCH) §404.04 (Oct. 21, 1969).

funds must determine the fair value of the security.<sup>247</sup> In addition, funds must use fair values, rather than market quotations, to value their portfolio securities if an event that affects the value of a security occurs after the relevant market has closed, but before the funds calculate their NAV.<sup>248</sup>

The 1940 Act places the responsibility for fair value pricing portfolio securities with mutual fund boards. In practice, most boards formulate and adopt pricing methodologies and procedures and delegate the actual day-to-day calculation of those prices to others, such as the fund's investment adviser.<sup>249</sup> In addition, many funds obtain pricing information from independent pricing services. Pricing services may provide funds with closing prices for securities that are traded on exchanges and markets, as well as evaluated prices of other securities that are derived from proprietary matrices or other pricing methodologies. Funds may use the evaluated prices provided by pricing services to assist them in determining the fair value of their portfolio securities. Funds also should institute measures to periodically determine the reliability and accuracy of prices provided by pricing services. In any event, the ultimate responsibility for the valuations used by a fund to calculate its NAV remains with the fund's board of directors.

Funds occasionally hold relatively large positions, or blocks, in securities for which market quotations are readily available. Funds historically have valued those blocks using the market values of the securities, without applying a discount. This

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<sup>247</sup> See ASR No. 118 *supra* note 244.

<sup>248</sup> Investment Company Act Release No. 14244 (Nov. 21, 1984), at n.7. See also Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Apr. 30, 2001).

<sup>249</sup> To the extent considered necessary, the fund's board of directors may appoint persons to assist them in determining fair value, and to make the actual calculations pursuant to the board's direction. ASR No. 118, *supra* note 244.

practice is generally consistent with the 1940 Act requirement that funds use market quotations to value their portfolio securities for which market quotations are readily available. In addition, valuing a block position at a discount from its market value could understate the value of the position, particularly if the discount reflected the unlikely event that the fund would sell its entire block position at the same time. In practice, funds generally seek to liquidate block positions over an extended period of time in order to obtain the most favorable market prices and avoid depressing the market price.